



TAXWATCH

March 26, 2009, 8:51 p.m. EDT

Injury, sure, but hold the insult

Facing a tax bill on cancelled debt? There is a way out

By [Eva Rosenberg](#), MarketWatch

LOS ANGELES (MarketWatch) -- Many folks have lost a job or watched their income plummet during this financial crisis, and that's meant more people defaulting on their credit-card or other loans.

So here you are, in early 2009, having defaulted on your credit card debt and ruined your credit -- and you're staring at a 1099-C. After losing so much already, you face the added difficulty of owing taxes on cancellation-of-debt income.

Talk about being in the pit of despair. Where are you going to get the money to pay these taxes when you have absolutely nothing left to tap?

Hold on a second!

You might be able to avoid those extra taxes altogether, said Bill Fleming, a managing director in PricewaterhouseCoopers' Private Company Services Practice.

The rules and computations are complicated, so you may need some help. But the great news is this method does not require you to file bankruptcy.

Insolvency 101

This technique is as old as the hills. There's even a form to use to let IRS know how much cancelled debt doesn't need to be taxed because you are insolvent. [See Form 982 on the IRS site \(PDF\)](#).

Use Line 1b for credit card debt. You can see there are other lines for business real estate and your personal residence. Unfortunately, despite four pages of instructions that come with this form, IRS does not provide a worksheet to help you calculate just how insolvent you are.

Why is that important? You can only exclude cancelled debt from your income up to the amount that you are insolvent before the debt was cancelled, Fleming said. So let's say you get a 1099-C that shows the lender wrote off \$50,000 of credit card debt on June 15. You will need to create your own worksheet summarizing your assets and debt, including this \$50,000 debt. For this calculation, remember to include the balances in your IRAs and

retirement accounts. (According to Fleming, in a bankruptcy, you wouldn't need to take these funds into account.)

Tax programs for tough jobs

Tax-preparation Web sites such as TurboTax Online, H&R Block Online and TaxACT will help you figure your options in a year that will see many significant changes in tax policy.

MORE TAX ADVICE, IRS NEWS AND FILING HELP

- [Estate taxes will rise from the dead yet](#)
- [Retroactive estate-tax fix no easy task](#)
- [Higher rates ahead in 2011, so prepare now](#)
- [The tax benefits of refinancing your mortgage](#)
- [The happiest places are the most heavily taxed](#)
- [Filing online or off, don't ignore ID-theft risks](#)
- [Unemployed? Here are 4 costly tax-filing errors](#)
- [Get rid of your tax bill on canceled debt](#)
- [Five reasons not to itemize your deductions](#)
- [The red flags that will make you IRS audit bait](#)
- [How to deal with the IRS to resolve tax errors](#)
- [How to find the right tax professional](#)
- [You may qualify for free e-file service](#)

[See the complete MarketWatch Guide to Taxes](#)

To really simplify the explanation, the amount of your insolvency on that day is the difference between your total debt and your assets. So, suppose that on June 15 your total debt, including mortgages and unpaid taxes, add up to \$450,000. Let's say that on that day, the fair market value of your home, savings and retirement accounts, the cash value of your insurance policies, used cars, furniture and personal property all add up to \$405,000.

That means, on the date shown on that 1099-C, you were only insolvent up to \$45,000 ($\$450,000 - \$405,000$). That means you will have to pay tax on \$5,000 of the cancelled debt.

You're going to want to do this worksheet on the date that each separate debt was cancelled, Fleming said. That's a twist many people overlook when they do insolvency calculations.

After all, when the debts get cancelled on different dates, you will have a different balance as each successive debt is cancelled. You will also have a different balance of assets and money in the bank on each date.

For instance, suppose you have another \$25,000 credit card debt cancelled on Oct. 1. By this time, the value of your retirement portfolio has dropped dramatically (down \$30,000), as did the value of your home (down \$100,000).

Using the same debts as before, less the \$50,000 that was cancelled in June, your new balance of debts will be \$400,000.

That is, your new asset balance with those declines in fair market value will be \$275,000 ($\$405,000$ less retirement-plan drop of \$30,000 and home-value decline of \$100,000). On Oct. 1 you are insolvent to the tune of \$125,000 ($\$400,000 - \$275,000$). As a result, on that day the entire \$25,000 cancelled debt is excluded from income. It was worth doing a second calculation, right?

Let's face it, if you're at the point where the credit card companies and other lenders are writing your debt off as uncollectible, you're probably insolvent, even without filing for bankruptcy. It's just a matter of proving it to IRS.

A price for insolvency

Naturally, to take this cheaper, easier, non-bankruptcy option to get out of tax, there's a price. You must have proof of your debt and asset balances at each date. Fleming said that the higher the amount of cancelled debt you exclude from income, the more careful you want to be with your back-up documents. In some instances, it may be worth the price to pay for appraisals showing the value of key assets on the specific dates.

You can get free documentation of some asset values on the Internet. For instance, MarketWatch has a tool to help you get stock values on specific dates. [See the tool.](#)

You can get vehicle values at Kelly Blue Book (KBB.com) and Edmunds.com.

You may be able to find the value of other personal assets on eBay.com or even use TurboTax's ItsDeductible tool, which is now free. [See the site.](#)

Keep copies of loan balances on those dates. Get them from the lenders and put a copy of the documents in your tax file. You don't need to send any of this to IRS. But the larger the excluded balances, the higher your chance of getting audited.

Yet another price

Look back at Form 982. Do you see Part II where it says "Reduction of Tax Attributes"? This is where you're going to take the amount of the excluded debt and reduce a variety of tax benefits you've been carrying over for a while. You'll lose net operating loss carryovers, foreign tax credits, capital loss carryovers and more.

Remember, you still have to report the income from that 1099-C on your tax return. But you will also get to remove the income by following the instructions on Form 982.

Can't do it alone? Get help!

Start with the guidance on the IRS site, which has links to resources to help you with insolvency and the special relief rules for residential real estate from the Mortgage Forgiveness Debt Relief Act of 2007, which we haven't discussed here. [See more on IRS.gov.](#)

Folks who want to avoid a lot of tax on this phantom income, be darn sure you get these computations right. Consider investing a little money in a tax professional with experience dealing with insolvency. This is too important to trust to someone who's learning on your dime and your time. You don't want to find out two years from now that you did it all wrong and suddenly have to pay taxes you didn't expect.

Still, if the tax professional makes a mistake, typically the IRS will be more lenient with the penalties than if you made the error. After all, you can prove that you made a good faith effort to get it right.

How do you know someone really has experience? Bill Fleming came up with a great idea: Ask the tax pros if they have a standard worksheet or spreadsheet you can fill out to give them the information for the debts cancelled at different times during the year.

Wait for a response. If you get a blank look, give the person a clue: "You know, since my asset and liability balances were probably different on the date of each cancelled debt?"

Still getting a blank look? Get out fast. Repeat the process until you find someone who understands.

Intraday data provided by Interactive Data Real Time Services, a division of Interactive Data Corp. and subject to terms of use. Historical and current end-of-day data provided by Interactive Data Pricing and Reference Data. More information on NASDAQ traded symbols and their current financial status. Intraday data delayed 15 minutes for Nasdaq, and 20 minutes for other exchanges. Dow Jones Indexes(SM) from Dow Jones & Company, Inc. SEHK intraday data is provided by Comstock and is at least 60-minutes delayed. All quotes are in local exchange time. Real-time last sale data provided by NASDAQ.