



Department
of the
Treasury

Internal
Revenue
Service

Publication 4681
Cat. No. 51508F

Canceled Debts, Foreclosures, Repossessions, and Abandonments

(for Individuals)

For use in preparing
2007 Returns



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Contents

What's New for 2007	1
Reminder	2
Introduction	2
How To Use This Publication	2
Canceled Debts	3
Exceptions	3
Amounts Otherwise Excluded From Income	3
Student Loans	3
Deductible Debt	4
Price Reduced After Purchase	4
Exclusions	4
Bankruptcy	4
Insolvency	4
Qualified Farm Indebtedness	5
Qualified Real Property Business Indebtedness	5
Qualified Principal Residence Indebtedness	6
Reduction of Tax Attributes	7
Qualified Principal Residence Indebtedness	7
Bankruptcy and Insolvency	7
Qualified Farm Indebtedness	8
Qualified Real Property Business Indebtedness	8
Foreclosures and Repossessions	9
Abandonments	10
Detailed Examples	10
How To Get Tax Help	18

What's New for 2007

Canceled debt on your principal residence. If you had debt canceled on your principal residence in 2007, you may be able to exclude part or all of the amount canceled from your income. However, if you continue to own your residence after the cancellation, you must reduce the basis of your principal residence (but not below zero) by the amount excluded from income. For more information, see *Qualified Principal Residence Indebtedness*, later.

Expiration of exclusion of debt canceled because of Hurricane Katrina. The exclusion for canceled nonbusiness debt by certain persons whose principal residence on August 25, 2005, was located in the Hurricane Katrina disaster area is not available after 2006. If you were eligible to exclude such income in 2005 or 2006, you must use the January 2006 revision of Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).

Reminder

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that otherwise would be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Introduction

This publication explains the federal tax treatment of canceled debts, foreclosures, repossessions, and abandonments.

Generally, if you owe a debt to someone else and they cancel or forgive that debt, you are treated for income tax purposes as having income and may have to pay tax on this income. This publication refers to this as “canceled debt” whether it is canceled or forgiven. However, under certain circumstances, you may not have to include canceled debt in income. If you do exclude canceled debt from income, you may also be required to reduce “tax attributes.” Reduction of tax attributes is discussed in more detail later in this publication.

If you have property that is security for a debt and that property is taken by the lender in full or partial satisfaction of your debt, you will be treated as having sold that property and may have gain or loss as a result. For this purpose, it does not matter whether the lender took the property through foreclosure, repossession, a voluntary conveyance by you to the lender, or your abandonment of the property. If the lender cancels debt in excess of the fair market value (FMV) of the property taken by the lender, the excess of the canceled debt over the FMV of the property may have to be treated by you as ordinary income from the cancellation of debt in addition to any taxable gain that you may have had from being treated as having sold the property.

If you are treated as having sold the property, any gain you have will generally have to be reported on your income tax return. If you have a loss, you may be entitled to deduct the loss if the property that was returned to the lender is business or investment property, but not if it is personal use property, such as your residence.

This publication discusses the general rule requiring canceled debt to be included in income, exceptions to the general rule, exclusions from the general rule, and the ordering rules for reduction of tax attributes by reason of the exclusion of canceled debt from income. This publication also discusses the tax treatment resulting from foreclosures, repossessions, and abandonments and provides detailed examples with filled-in forms.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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Tax questions. If you have a tax question, check the information available on *www.irs.gov* or call 1-800-829-1040. We cannot answer tax questions sent to either of the above addresses.

Useful Items

You may want to see:

Publication

- 225** Farmer’s Tax Guide
- 334** Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- 523** Selling Your Home
- 525** Taxable and Nontaxable Income
- 535** Business Expenses
- 544** Sales and Other Dispositions of Assets
- 551** Basis of Assets
- 908** Bankruptcy Tax Guide

Form (and Instructions)

- 982** Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

How To Use This Publication

The sections of this publication that will apply to you depend on the type of debt canceled, the tax attributes you have, and whether or not you

continue to own the property that was subject to the debt. Some examples illustrating common circumstances are provided below to help guide you through this publication. These examples do not cover every canceled debt situation, but are intended to provide general guidance for the most common situations.

Nonbusiness credit card debt cancellation. If you had a nonbusiness credit card debt canceled, you may be able to exclude the canceled debt from income if the cancellation occurred in a title 11 bankruptcy case or if you were insolvent immediately before the cancellation. You should read *Bankruptcy or Insolvency* under *Exclusions* in Chapter 1 to see if you can exclude the canceled debt from income under one of those provisions. If you can exclude part or all of the canceled debt from income, you should also read *Bankruptcy and Insolvency* under *Reduction of Tax Attributes* in Chapter 1.

Personal vehicle repossession. If you had a personal vehicle repossessed during the year, you will need to determine your gain or nondeductible loss on the repossession. This is explained in Chapter 2. If the lender also canceled all or part of the remaining amount on the loan, you may be able to exclude the canceled debt from income if the cancellation occurred in a title 11 bankruptcy case or if you were insolvent immediately before the cancellation. You should read *Bankruptcy or Insolvency* under *Exclusions* in Chapter 1 to see if you can exclude the canceled debt from income under one of those provisions. If you can exclude part or all of the canceled debt from income, you should also read *Bankruptcy and Insolvency* under *Reduction of Tax Attributes* in Chapter 1.

Principal residence foreclosure or abandonment. If a lender foreclosed on your principal residence during the year, you will need to determine your gain or nondeductible loss on the foreclosure or abandonment. Foreclosures are explained in Chapter 2 and abandonments are explained in Chapter 3. If the lender also canceled all or part of the remaining amount on the mortgage loan and you were personally liable for the debt, you should also read *Qualified Principal Residence Indebtedness* under *Exclusions* in Chapter 1 to see if you can exclude part or all of the canceled debt from income. Detailed examples 2 and 3 in Chapter 4 use filled-in forms to help explain these provisions.

Principal residence loan modification (workout agreement). If a lender agrees to a mortgage loan modification (a “workout”) that includes a reduction in the principal balance of the loan, you should read *Qualified Principal Residence Indebtedness* under *Exclusions* in Chapter 1 to see if you can exclude part or all of the canceled debt from income. If you can exclude part or all of the canceled debt from income, you should also read *Qualified Principal Residence Indebtedness* under *Reduction of Tax Attributes* in Chapter 1. Detailed example 1 in Chapter 4 uses filled-in forms to help explain the tax implications of a mortgage workout scenario.

1.

Canceled Debts

Generally, if a debt for which you are personally liable is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your income. A debt includes any indebtedness for which you are liable or which attaches to property you hold. Debt for which you are personally liable is recourse debt. All other debt is nonrecourse debt.

If you are not personally liable for the debt, you do not have ordinary income from the cancellation of debt unless the lender offers a discount for the early payment of the debt or agrees to a loan modification that results in the reduction of the principal balance of the debt. See *Discounts and loan modifications*, later. Also, upon the disposition of the property securing a nonrecourse debt, the amount realized includes the entire unpaid amount of the debt. As a result, you may realize a gain or loss if the outstanding debt immediately before the transfer differs from your adjusted basis in the property to which the debt relates. See Chapter 2, *Foreclosures and Repossessions*, or Publication 544, *Sales and Other Dispositions of Assets*, for more details on figuring your gain or loss.

There are several exceptions and exclusions that may result in part or all of your income from the cancellation of debt being nontaxable. See *Exceptions and Exclusions*, later. You must report any taxable amount as ordinary income from the cancellation of debt on:

- Form 1040 or Form 1040NR, line 21, if the debt is a nonbusiness debt;
- Schedule C (Form 1040), line 6 (or Schedule C-EZ (Form 1040), line 1), if the debt is related to a nonfarm sole proprietorship;
- Schedule E (Form 1040), line 3, if the debt is related to a nonfarm rental activity;
- Form 4835, line 6, if the debt is related to a farm rental activity for which you use Form 4835 to report farm rental income based on crops or livestock produced by a tenant; or
- Schedule F (Form 1040), line 10, if the debt is farm debt and you are a farmer.

Form 1099-C. If an applicable financial entity cancels or forgives a debt you owe of \$600 or more, you will receive a Form 1099-C, *Cancellation of Debt*. The amount of the canceled debt is shown in box 2. Unless you meet one of the exceptions or exclusions discussed later, the canceled debt shown on Form 1099-C, box 2, is ordinary income from the cancellation of debt and must be reported on the appropriate form shown above.

An applicable financial entity includes:

- A federal government agency,
- A financial institution,
- A credit union, or

- Any organization in which a significant part of its trade or business involves the lending of money.

Interest included in canceled debt. If any interest is forgiven and included in the amount of canceled debt in box 2, the interest portion that is included in box 2 will be shown in box 3. Whether the interest portion of the canceled debt must be included in your income depends on whether the interest would be deductible if you paid it. See *Deductible Debt* under *Exceptions*, later.

If the interest would not be deductible (such as interest on a personal loan) and you do not meet any other exception or exclusion discussed later, include in your income the amount from Form 1099-C, box 2. If the interest would be deductible (such as on a business loan) and you do not meet any other exception or exclusion discussed later, include in your income the net amount of the canceled debt (the amount shown in box 2 minus the interest amount shown in box 3).

Discounts and loan modifications. If a lender offers to discount (reduce) the principal balance of a loan if the loan is paid off early or agrees to a loan modification (a “workout”) that includes a reduction in the principal balance of a loan, the amount of the discount or the amount of principal reduction is canceled debt whether or not you are personally liable for the debt. The amount of the canceled debt must be included in income unless certain exceptions or exclusions apply. For more details, see *Exceptions and Exclusions*, later.

Sales or other dispositions (such as foreclosures and repossessions). If you owned property which was subject to a recourse debt in excess of the FMV of the property, the lender’s foreclosure or repossession of the property may result in your realization of gain or loss on the disposition of the property. If the lender forgives all or part of the amount of the debt in excess of the FMV of the property, ordinary income may result from the cancellation of debt. The gain or loss on the disposition of the property is measured by the difference between the FMV of the property at the time of the disposition and your adjusted basis (usually your cost) in the property. The character of the gain or loss (such as ordinary or capital) on the disposition of the property is determined on the basis of the character of the property foreclosed. The ordinary income from the cancellation of debt (the excess of the canceled debt over the FMV of the property) must be included on your tax return unless certain exceptions or exclusions apply. For more details, see *Exceptions and Exclusions*, later.

If you owned property which was subject to a nonrecourse debt in excess of the FMV of the property, the lender’s foreclosure on the property does not result in ordinary income from the cancellation of debt. The entire amount of the nonrecourse debt is treated as an amount realized on the disposition of the property. The gain or loss on the disposition of the property is measured by the difference between the total amount realized (the entire amount of the nonrecourse debt plus the amount of cash and the FMV of any property received) and your adjusted basis in the property foreclosed. The character of the gain or loss on the disposition of

the property is determined on the basis of the character of the property foreclosed.

See Publication 523, *Selling Your Home*; Publication 544, *Sales and Other Dispositions of Assets*; Chapter 2, *Foreclosures and Repossessions*; and Publication 551, *Basis of Assets*; for more details.

Abandonments. If the abandoned property secures a debt for which you are personally liable and the debt is canceled, you will realize ordinary income equal to the canceled debt. You must report this income on your return unless certain exceptions or exclusions apply. For more details, see *Exceptions and Exclusions*, later. This income is separate from any loss realized from the abandonment of the property. For more details, see Chapter 3, *Abandonments*.

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is a constructive distribution that is generally dividend income to you. For more information, see Publication 542, *Corporations*.

Repayment of canceled debt. If you included a canceled amount in your income and later pay all or a portion of the debt, you may be able to file a claim for refund for the year the amount was included in income. You can file a claim on Form 1040X, Amended U.S. Individual Income Tax Return, if the statute of limitations for filing a claim is still open. The statute of limitations generally does not end until 3 years after the due date of your original return.

Exceptions

There are several exceptions to the inclusion of canceled debt in income. These exceptions apply before the exclusions discussed later.

Amounts Otherwise Excluded From Income

Amounts otherwise excluded from income do not result in income from the cancellation of debt. For example, you have no income from the cancellation of debt if the cancellation of the debt is intended as a gift to you. See Publication 525, *Taxable and Nontaxable Income*, for more details on amounts that are excluded from income.

Student Loans

Certain student loans contain a provision that all or part of the debt incurred to attend the qualified educational institution will be canceled if you work for a certain period of time in certain professions for any of a broad class of employers.

You do not have income from the cancellation of debt if your student loan is canceled after you agreed to this provision and then performed the services required. To qualify, the loan must have been made by:

1. The federal government, a state or local government, or an instrumentality, agency, or subdivision thereof,
2. A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose

employees are considered public employees under state law, or

3. An educational institution (defined later):
 - a. Under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan, or
 - b. As part of a program of the institution designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization (defined later).

A loan to refinance a qualified student loan also will qualify if it was made by an educational institution or a tax-exempt section 501(a) organization under its program designed as described in (3)(b) above.

Exception. You have ordinary income from the cancellation of debt if your student loan was made by an educational institution and is canceled because of services you performed for the institution or other organization that provided the funds. You must include this income on your return unless other exceptions or exclusions apply.

Education loan repayment assistance. Education loan repayments made to you by the National Health Service Corps Loan Repayment Program or a state education loan repayment program eligible for funds under the Public Health Service Act are not taxable if you agree to provide primary health services in health professional shortage areas.

Educational institution. An educational institution is an organization with a regular faculty and curriculum and a regularly enrolled body of students in attendance at the place where the educational activities are carried on.

Section 501(c)(3) organization. A section 501(c)(3) organization is any corporation, community chest, fund, or foundation organized and operated exclusively for one or more of the following purposes.

- Charitable.
- Educational.
- Fostering national or international amateur sports competition (but only if none of the organization's activities involve providing athletic facilities or equipment).
- Literary.
- Preventing cruelty to children or animals.
- Religious.
- Scientific.
- Testing for public safety.

Deductible Debt

If you use the cash method of accounting, you do not realize income from the cancellation of debt if the payment of the debt would have been a deductible expense. This exception applies

before the price reduction exception discussed below.

Example. You get accounting services for your farm on credit. Later, you have trouble paying your farm debts and your accountant forgives part of the amount you owe for the accounting services. How you treat the canceled debt depends on your method of accounting.

- Cash method. You do not include the canceled debt in income because payment of the debt would have been deductible as a business expense.
- Accrual method. Unless another exception or exclusion applies, you must include the canceled debt in ordinary income because the expense was deductible when you incurred the debt.

Price Reduced After Purchase

If debt you owe the seller for the purchase of property is reduced by the seller at a time when you are not insolvent and the reduction does not occur in a title 11 bankruptcy case, the reduction does not result in cancellation of debt income. However, you must reduce your basis in the property by the amount of the reduction of your debt to the seller. The rules that apply to bankruptcy and insolvency are explained in the next section, *Exclusions*.

Exclusions

There are several exclusions from the general rule of inclusion of canceled debt in income. These are explained next. Generally, if you exclude canceled debt from income under one of these provisions, you must also reduce your tax attributes (certain credits, losses, and basis of assets) as explained later under *Reduction of Tax Attributes*.

Bankruptcy

Debt canceled in a title 11 bankruptcy case is not included in your income. A title 11 bankruptcy case is a case under title 11 of the United States Code, but only if the debtor is under the jurisdiction of the court and the cancellation of the debt is granted by the court or occurs as a result of a plan approved by the court.

How to report the bankruptcy exclusion. To show that your debt was canceled in a bankruptcy case and is excluded from income, attach Form 982 to your federal income tax return and check the box on line 1a. Lines 1b through 1e do not apply to a cancellation that occurs in a title 11 bankruptcy case. Enter the total amount of debt canceled in your title 11 bankruptcy case on line 2. You must also reduce your tax attributes in Part II of Form 982 as explained under *Reduction of Tax Attributes*, later.

Insolvency

Do not include a canceled debt in income to the extent that you were insolvent immediately

before the cancellation. You were insolvent immediately before the cancellation to the extent that the total of all of your liabilities exceeded the FMV of all of your assets immediately before the cancellation. For purposes of determining insolvency, assets include the value of everything you own (including assets that serve as collateral for debt and exempt assets which are beyond the reach of your creditors under the law, such as your interest in a pension plan and the value of your retirement account). Liabilities include:

- The entire amount of recourse debts, and
- The amount of nonrecourse debt that is not in excess of the FMV of the property that is security for the debt.

Note. This exclusion does not apply to a cancellation that occurs in a title 11 bankruptcy case. This exclusion also does not apply if the debt is qualified principal residence indebtedness (defined in this section under *Qualified Principal Residence Indebtedness*, later) unless you elect to apply the insolvency exclusion instead of the qualified principal residence indebtedness exclusion.

How to report the insolvency exclusion. To show that you were insolvent and that you are excluding canceled debt from income to the extent you were insolvent immediately before the cancellation, attach Form 982 to your federal income tax return and check the box on line 1b. On line 2, include the smaller of the amount of the debt canceled or the amount by which you were insolvent immediately before the cancellation. You must also reduce your tax attributes in Part II of Form 982 as explained under *Reduction of Tax Attributes*, later.

Example 1. In 2007, Greg was released from his obligation to pay his personal credit card debt in the amount of \$5,000. Greg received a 2007 Form 1099-C from his credit card lender showing canceled debt of \$5,000 in box 2. The FMV of Greg's total assets immediately before the cancellation was \$7,000 and his total liabilities were \$15,000. This means that immediately before the cancellation, Greg was insolvent to the extent of \$8,000 (\$15,000 total liabilities minus \$7,000 FMV of his total assets). Because the amount by which Greg was insolvent immediately before the cancellation exceeds the amount of his debt canceled, Greg can exclude the entire \$5,000 canceled debt from income.

When completing his tax return, Greg checks the box on line 1b of Form 982 and enters \$5,000 on line 2. Greg completes Part II to reduce his tax attributes as explained under *Reduction of Tax Attributes*, later. Greg does not include any of the \$5,000 canceled debt on line 21 of his Form 1040. None of the canceled debt is included in his income.

Example 2. Assume the same facts as in Example 1 except that the FMV of Greg's total assets immediately before the cancellation was \$7,000 and his total liabilities were \$10,000. In this case, Greg is insolvent to the extent of \$3,000 (\$10,000 total liabilities minus \$7,000 FMV of his total assets) immediately before the

cancellation. Because the amount of the canceled debt exceeds the amount by which Greg was insolvent immediately before the cancellation, Greg can exclude only \$3,000 of the \$5,000 canceled debt from income under the insolvency exclusion.

Greg checks the box on line 1b of Form 982 and includes \$3,000 on line 2. Also, Greg completes Part II to reduce his tax attributes as explained under *Reduction of Tax Attributes*, later. Additionally, Greg must include \$2,000 of canceled debt on line 21 of his Form 1040 (unless another exception or exclusion applies).

Qualified Farm Indebtedness

You can exclude canceled farm debt from income if all of the following apply.

- The debt was incurred directly in connection with the operation of the trade or business of farming.
- 50% or more of your total gross receipts for 2004, 2005, and 2006 were from the trade or business of farming.
- The cancellation was made by a qualified person. A qualified person is an individual, organization, etc., who is actively and regularly engaged in the business of lending money. A qualified person includes any federal, state, or local government, agency or instrumentality thereof. The United States Department of Agriculture is a qualified person. This person cannot be related to you, be the person from whom you acquired the property (or a person related to this person), or be a person who receives a fee due to your investment in the property (or a person related to this person).

For the definition of the term “related person,” see *Related persons* under *At-Risk Amounts* in Publication 925.

Note. This exclusion does not apply to a cancellation of debt in a title 11 bankruptcy case or to the extent you were insolvent immediately before the cancellation. If qualified farm debt is canceled in a title 11 case, you must apply the bankruptcy exclusion rather than the exclusion for canceled qualified farm debt. If you were insolvent immediately before the cancellation of qualified farm debt, you must apply the insolvency exclusion before applying the exclusion for canceled qualified farm debt.

Exclusion limit. The amount of canceled qualified farm debt that you can exclude from income is limited. It cannot exceed the sum of your adjusted tax attributes and the total adjusted bases of qualified property you held at the beginning of 2008. For purposes of determining the limit on the exclusion for canceled qualified farm debt, the adjusted basis of any qualified property and adjusted tax attributes are determined after any reduction of tax attributes required because of the application of the insolvency exclusion for canceled debt.

Adjusted tax attributes. Adjusted tax attributes means the sum of the following items.

1. Any net operating loss (NOL) for 2007 and any NOL carryover to 2007.

2. Any net capital loss for 2007 and any capital loss carryover to 2007 under Internal Revenue Code section 1212.
3. Any passive activity loss carryover from 2007.
4. Three times the sum of any:
 - a. General business credit carryover to or from 2007,
 - b. Minimum tax credit available as of the beginning of 2008,
 - c. Foreign tax credit carryover to or from 2007, and
 - d. Passive activity credit carryover from 2007.

Qualified property. This is any property you use or hold for use in your trade or business or for the production of income.

How to report the qualified farm indebtedness exclusion. To show that all or part of your canceled debt is excluded from income because it is qualified farm debt, attach Form 982 to your federal income tax return and check the box on line 1c. On line 2 of Form 982, include the amount of qualified farm debt canceled, but not more than the amount of the exclusion limit (explained earlier). You must also reduce your tax attributes in Part II of Form 982 as explained under *Reduction of Tax Attributes*, later.

Example 1. In 2007, Chuck was released from his obligation to pay a \$10,000 debt that was incurred directly in connection with his trade or business of farming. Chuck received a Form 1099-C from the qualified lender showing canceled debt of \$10,000 in box 2. For the 2004, 2005, and 2006 tax years, at least 50% of Chuck’s total gross receipts were from the trade or business of farming. Chuck’s adjusted tax attributes are \$5,000 and Chuck has \$3,000 total adjusted bases in qualified property at the beginning of 2008. Chuck had no other debt canceled during 2007 and he does not fall into any other exception or exclusion relating to canceled debt income.

Chuck can exclude \$8,000 (\$5,000 of adjusted tax attributes plus \$3,000 total adjusted bases in qualified property at the beginning of 2008) of the \$10,000 canceled debt from income. Chuck checks the box on line 1c of Form 982 and enters \$8,000 on line 2. Also, Chuck completes Part II to reduce his tax attributes as explained under *Reduction of Tax Attributes*, later. The remaining \$2,000 of canceled qualified farm debt is included in Chuck’s income on Schedule F, line 10.

Example 2. On March 1, 2007, Bob was released from his obligation to pay a \$10,000 business credit card debt that was used directly in connection with his farming business. For the 2004, 2005, and 2006 tax years at least 50% of Bob’s total gross receipts were from the trade or business of farming. Bob received a 2007 Form 1099-C from the qualified lender showing canceled debt of \$10,000 in box 2. The FMV of Bob’s total assets on March 1, 2007 (immediately before the cancellation of the credit card debt) was \$7,000 and Bob’s total liabilities at that time were \$11,000. Bob’s adjusted tax attributes (a 2007 NOL) are \$7,000 and Bob has

\$4,000 total adjusted bases in qualified property at the beginning of 2008.

Bob qualifies to exclude \$4,000 of the canceled debt under the insolvency exclusion because he is insolvent to the extent of \$4,000 immediately before the cancellation (\$11,000 total liabilities minus \$7,000 FMV of total assets). Bob also qualifies to exclude the remaining \$6,000 of canceled qualified farm debt. The limit on Bob’s exclusion from income of canceled qualified farm debt is \$7,000, the sum of his adjusted tax attributes of \$3,000 (determined after taking into account the reduction of tax attributes required because of the exclusion of \$4,000 of the canceled debt from Bob’s income under the insolvency exclusion) plus \$4,000 (Bob’s total adjusted bases in qualified property at the beginning of 2008).

Bob checks the boxes on lines 1b and 1c of Form 982 and enters \$10,000 on line 2. Bob completes Part II to reduce his tax attributes as explained under *Reduction of Tax Attributes*, later. Bob must reduce his tax attributes under the insolvency rules before applying the rules for qualified farm debt. Bob does not include any of his canceled debt in income.

Example 3. Assume the same facts as in Example 2 except that immediately before the cancellation Bob was insolvent to the extent of the full \$10,000 canceled debt. Because the exclusion for qualified farm debt does not apply to the extent that you were insolvent immediately before the cancellation, Bob checks only the box on line 1b of Form 982 and enters \$10,000 on line 2. Bob completes Part II to reduce his tax attributes based on the insolvency exclusion as explained under *Reduction of Tax Attributes*, later. Bob does not include any of the canceled debt in income.

Qualified Real Property Business Indebtedness

You can elect to exclude canceled qualified real property business indebtedness from income. Qualified real property business indebtedness is debt (other than qualified farm debt) that meets all of the following conditions.

1. It was incurred or assumed in connection with real property used in a trade or business.
2. It is secured by such real property.
3. It was incurred or assumed at either of the following times.
 - a. Before 1993.
 - b. After 1992, if the debt is either (i) qualified acquisition indebtedness (defined below), or (ii) debt incurred to refinance qualified real property business debt incurred or assumed before 1993 (but only to the extent the amount of such debt does not exceed the amount of debt being refinanced).
4. It is debt to which you elect to apply these rules.

Qualified acquisition indebtedness. Qualified acquisition indebtedness is:

- Debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property that secures such debt, or
- Debt resulting from the refinancing of qualified acquisition indebtedness, to the extent the amount of such debt does not exceed the amount of debt being refinanced.

Note. This exclusion does not apply to a cancellation of debt in a title 11 bankruptcy case or to the extent you were insolvent immediately before the cancellation. If qualified real property business debt is canceled in a title 11 case, you must apply the bankruptcy exclusion rather than the exclusion for canceled qualified real property business debt. If you were insolvent immediately before the cancellation of qualified real property business debt, you must apply the insolvency exclusion before applying the exclusion for canceled qualified real property business debt.

Exclusion limit. The amount of canceled qualified real property business debt that you can exclude from income is limited. If you excluded canceled debt from income under the insolvency exclusion, you must reduce your tax attributes to account for the amount of the canceled debt excluded under the insolvency exclusion before determining your limit on the exclusion of canceled qualified real property business debt. Your exclusion for canceled qualified real property business debt is limited to the excess (if any) of:

- The outstanding principal amount of the qualified real property business debt (immediately before the cancellation), over
- The FMV (immediately before the cancellation) of the business real property securing such debt, reduced by the outstanding principal amount of any other qualified real property business debt secured by that property (immediately before the cancellation).

In addition to this limit, the amount of canceled qualified real property business debt that can be excluded from income cannot exceed the total adjusted bases (determined after any attribute reductions under Internal Revenue Code sections 108(b) and (g)) of depreciable real property you held immediately before the cancellation (other than depreciable real property acquired in contemplation of the cancellation).

How to elect the qualified real property business debt exclusion. You must make an election to exclude canceled qualified real property business debt. The election must be made on a timely-filed (including extensions) federal income tax return for 2007 and can be revoked only with the consent of the IRS. The election is made by completing Form 982 in accordance with its instructions. Attach Form 982 to your federal income tax return for 2007 and check the box on line 1d. Include the amount of canceled qualified real property business debt (but not more than the amount of the exclusion limit, explained above) on line 2 of Form 982. You must also reduce your tax attributes in Part II of Form 982 as explained under *Reduction of Tax Attributes*, later.

If you timely filed your tax return without making this election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Enter "Filed pursuant to section 301.9100-2" on the amended return and file it at the same place you filed the original return.

Example. In 2002, Curt purchased a retail store for use in a business he operated as a sole proprietorship. Curt made a \$20,000 down payment and financed the remaining \$200,000 of the purchase price with a bank loan. The bank loan was a recourse loan and was secured by the property. Curt used the property in his business continuously since its acquisition. Curt had no other debt secured by that depreciable real property. In addition to the retail store, Curt owned depreciable equipment and furniture with an adjusted basis of \$50,000.

Curt's business encountered financial difficulties in 2007. On September 25, 2007, the bank financing the retail store loan entered into a workout agreement with Curt under which it canceled \$20,000 of the debt. Immediately before the cancellation, the outstanding principal balance on the retail store loan was \$185,000, the FMV of the store was \$165,000, and the adjusted basis was \$210,000 (\$220,000 cost minus \$10,000 accumulated depreciation).

The bank sent Curt a 2007 Form 1099-C showing canceled debt of \$20,000 in box 2. Curt had no tax attributes other than basis to reduce and did not qualify for any exception or exclusion other than the qualified real property business indebtedness exclusion.

Curt elects to apply the qualified real property business debt exclusion provisions to the canceled debt. The amount of canceled qualified real property business debt that Curt can exclude from income is limited to \$20,000 (the excess of the \$185,000 outstanding principal amount of his qualified real property business debt immediately before the cancellation over the \$165,000 FMV of the business real property securing such debt). Curt's exclusion of canceled qualified real property business debt is also subject to a \$210,000 limit equal to the adjusted basis of depreciable real property he held immediately before the cancellation.

Thus, Curt can exclude the entire \$20,000 of canceled qualified real property business debt from income. Curt checks the box on line 1d of Form 982 and enters \$20,000 on line 2. Curt must also use line 4 of Form 982 to reduce his basis in depreciable real property by the \$20,000 of canceled qualified real property business debt excluded from his income as explained under *Reduction of Tax Attributes*, later.

Qualified Principal Residence Indebtedness

You can exclude canceled debt from income if it is qualified principal residence indebtedness. Qualified principal residence indebtedness is any debt incurred in acquiring, constructing, or substantially improving your principal residence and which is secured by your principal residence. Qualified principal residence indebtedness also includes any debt secured by your principal residence resulting from the refinancing of debt incurred to acquire, construct, or substantially improve your principal residence

but only to the extent the amount of debt does not exceed the amount of the refinanced debt.

Example. In 1995, Becky purchased a principal residence for \$315,000. Becky took out a \$300,000 mortgage loan to buy the principal residence and made a down payment of \$15,000. The loan was secured by the principal residence. In 1996, Becky took out a second mortgage loan in the amount of \$50,000 that she used to add a garage to her home.

In 2001, when the outstanding principal of her first and second mortgage loans was \$325,000, Becky refinanced the two loans into one loan in the amount of \$400,000. The FMV of the principal residence at the time of the refinancing was \$430,000. Becky used the additional \$75,000 debt (\$400,000 new mortgage loan minus \$325,000 outstanding principal balances of Becky's first and second mortgage loans immediately before the refinancing) to pay off personal credit cards and to pay college tuition for her daughter.

After the refinancing, Becky's qualified principal residence indebtedness is \$325,000 because the debt resulting from the refinancing is qualified principal residence indebtedness only to the extent the amount of debt does not exceed the amount of the refinanced debt.

Principal residence. Your principal residence is the home where you ordinarily live most of the time. You can have only one principal residence at any one time.

Note. This exclusion does not apply to a cancellation of debt in a title 11 bankruptcy case. If qualified principal residence indebtedness is canceled in a title 11 bankruptcy case, you must apply the bankruptcy exclusion rather than the exclusion for qualified principal residence indebtedness. If you were insolvent immediately before the cancellation, you can elect to apply the insolvency exclusion (as explained under *Insolvency*, earlier) instead of applying the qualified principal residence indebtedness exclusion. To do this, check the box on line 1b of Form 982 instead of the box on line 1e.

Exclusion limit. The maximum amount you can treat as qualified principal residence indebtedness is \$2 million (\$1 million if married filing separately). You cannot exclude canceled qualified principal residence indebtedness from income if the cancellation was for services performed for the lender or on account of any other factor not directly related to a decline in the value of your residence or to your financial condition.

Ordering rule. If only a part of a loan is qualified principal residence indebtedness, the exclusion from income for canceled qualified principal residence indebtedness applies only to the extent the amount canceled exceeds the amount of the loan (immediately before the cancellation) that is **not** qualified principal residence indebtedness. The remaining part of the loan may qualify for another exclusion, as discussed earlier.

Example. Ken incurred recourse debt of \$800,000 when he purchased his principal residence for \$880,000. When the FMV of the property was \$1,000,000, Ken refinanced the debt for \$850,000. At the time of the refinancing, the

principal balance of the original mortgage loan was \$740,000. Ken used the \$110,000 he obtained from the refinancing (\$850,000 minus \$740,000) to pay off his credit cards and to buy a new car.

About two years after the refinancing, Ken lost his job and was unable to get another position paying a comparable salary. Ken's residence had declined in value to between \$700,000 and \$750,000. Based on Ken's circumstances, the lender agreed to allow a short sale of the property for \$735,000 and to cancel the remaining \$115,000 of the \$850,000 debt. Under the ordering rule, Ken can exclude only \$5,000 of the canceled debt from his income under the exclusion for canceled qualified principal residence indebtedness (\$115,000 canceled debt minus the \$110,000 amount of the debt that was not qualified principal residence indebtedness). Ken must include the remaining \$110,000 of canceled debt in income on line 21 of his Form 1040 (unless another exception or exclusion applies).

How to report the qualified principal residence indebtedness exclusion. To show that all or part of your canceled debt is excluded from income because it is qualified principal residence indebtedness, attach Form 982 to your federal income tax return and check the box on line 1e. On line 2 of Form 982, include the amount of canceled qualified principal residence indebtedness, but not more than the amount of the exclusion limit (explained earlier). If you continue to own your residence after a cancellation of qualified principal residence indebtedness, you must reduce your basis in the residence as explained under *Reduction of Tax Attributes*, next.

Reduction of Tax Attributes

If you exclude canceled debt from income, you must reduce certain tax attributes (but not below zero) by the amount excluded. Use Part II of Form 982 to reduce your tax attributes. The order in which the tax attributes are reduced depends on the reason the canceled debt was excluded from income. If the total amount of canceled debt excluded from income (line 2 of Form 982) was more than your total tax attributes, the total reduction of tax attributes in Part II of Form 982 will be less than the amount on line 2.

Qualified Principal Residence Indebtedness

If you exclude the canceled qualified principal residence indebtedness from income and you continue to own the residence after the cancellation, you must reduce the basis of the residence (but not below zero) by the amount of the canceled qualified principal residence indebtedness excluded from income. Enter the amount of the basis reduction on line 10b of Form 982.

For more details on determining the basis of your principal residence, see Publication 523, *Selling Your Home*.

Bankruptcy and Insolvency

No tax attributes other than basis of personal use property. If the canceled debt you are excluding is a debt other than qualified principal residence indebtedness (such as a car loan or credit card debt) and you have no tax attributes other than the adjusted bases of personal use property you own (see the list of seven tax attributes, later), you must reduce the bases of the personal use property you held at the beginning of 2008 (in proportion to adjusted basis). Personal use property is any property that is not used in your trade or business nor held for investment (such as your home furnishings, vehicle, and residence). Include on line 10a of Form 982 the smallest of:

- The bases of your personal use property held at the beginning of 2008,
- The amount of the nonbusiness debt (other than qualified principal residence indebtedness) that you are excluding from income on line 2 of Form 982, or
- The excess of the total bases of the property and the amount of money you held immediately after the cancellation over your total liabilities immediately after the cancellation.

Example. In 2004, Kyra bought a car for personal use. The cost of the car was \$12,000. Kyra put down \$2,000 and took out a loan of \$10,000 to help with the purchase. The loan was a recourse loan, meaning that Kyra was personally liable for the full amount of the debt.

On December 7, 2007, when the balance of the loan was \$8,500, Kyra was unable to make payments and the lender repossessed the car. The car had a FMV of \$7,000 at the time of repossession. At the time of the repossession, the lender forgave the remaining \$1,500 balance due on the car loan (\$8,500 outstanding balance immediately before the repossession minus \$7,000 FMV).

Kyra's only other assets at the time of the cancellation are the furniture in her apartment which has a cost basis of \$5,000 and a FMV of \$3,000, jewelry with a basis of \$500 and a FMV of \$1,000, and a \$600 balance in her savings account. Thus, the FMV of Kyra's total assets immediately before the cancellation was \$11,600 (\$7,000 car plus \$3,000 furniture plus \$1,000 jewelry plus \$600 savings). Kyra also had an outstanding student loan balance of \$6,000 immediately before the cancellation, bringing her total liabilities at that time to \$14,500 (\$8,500 balance on car loan plus \$6,000 student loan balance). Other than the car, which was repossessed, Kyra held all of these assets at the beginning of 2008. The FMV and bases of the assets remained the same at the beginning of 2008.

Kyra received a 2007 Form 1099-C showing \$1,500 in box 2 (amount of debt canceled) and \$7,000 in box 7 (FMV of the property). Kyra can exclude all of \$1,500 canceled debt from income because at the time of the cancellation, she was insolvent to the extent of \$2,900 (\$14,500 of total liabilities immediately before the cancellation minus \$11,600 FMV of total assets at that time).

Kyra checks box 1b on Form 982 and enters \$1,500 on line 2. Kyra enters \$100 on line 10a (the smallest of: (a) the \$5,500 bases of Kyra's personal use property held at the beginning of 2008 (\$5,000 furniture plus \$500 jewelry), (b) the \$1,500 amount of nonbusiness debt she is excluding from income on line 2 of Form 982, or (c) the \$100 excess of the total bases of the property and the amount of money Kyra held immediately after the cancellation over Kyra's total liabilities at that time (\$5,500 bases of property held immediately after the cancellation plus \$600 savings minus \$6,000 student loan).

Kyra must reduce her bases in her property in proportion to her adjusted bases in the property. Thus, Kyra reduces her basis in the furniture by \$91 (\$100 x 5,000/5,500) and her basis in the jewelry by \$9 (\$100 x 500/5,500).

All other tax attributes. If the canceled debt is excluded by reason of bankruptcy or insolvency, you must use the excluded debt to reduce the following tax attributes (but not below zero) in the order listed unless you elect to reduce the basis of depreciable property first, as explained later. The reduction of tax attributes must be made after figuring your income tax liability for 2007.

1. **Net operating loss (NOL).** First reduce any 2007 NOL and then reduce any NOL carryover to 2007 in the order of the tax years from which the carryovers arose, starting with the earliest year. Reduce the NOL or carryover by one dollar for each dollar of excluded canceled debt.
2. **General business credit carryover.** Reduce the credit carryover to or from 2007. Reduce the credit carryovers to 2007 in the order in which they are taken into account for 2007. Reduce the carryover by 33 $\frac{1}{3}$ cents for each dollar of excluded canceled debt.
3. **Minimum tax credit.** Reduce the minimum tax credit available at the beginning of 2008. Reduce the credit by 33 $\frac{1}{3}$ cents for each dollar of excluded canceled debt.
4. **Capital loss.** First reduce any 2007 net capital loss and then any capital loss carryover to 2007. Reduce the capital loss or carryover by one dollar for each dollar of excluded canceled debt.
5. **Basis.** Reduce the bases of the property you hold at the beginning of 2008 in the following order (and within each category, in proportion to adjusted basis).
 - a. Real property (except inventory) used in your trade or business or held for investment that secured the canceled debt.
 - b. Personal property (except inventory and accounts and notes receivable) used in your trade or business or held for investment that secured the canceled debt.
 - c. Other property (except inventory, accounts and notes receivable, and real property held primarily for sale to customers) used in your trade or business or held for investment.

- d. Inventory, accounts and notes receivable, and real property held primarily for sale to customers.
- e. Personal use property (property not used in your trade or business nor held for investment).

Reduce the basis by one dollar for each dollar of excluded canceled debt. However, the reduction cannot be more than the excess of the total bases of the property and the amount of money you held immediately after the debt cancellation over your total liabilities immediately after the cancellation.

For allocation rules that apply to basis reductions for multiple canceled debts, see Regulations section 1.1017-1(b)(2). Also see *Election to reduce the basis of depreciable property before reducing other tax attributes*, later.

6. **Passive activity loss and credit carryovers.** Reduce the passive activity loss and credit carryovers from 2007. Reduce the loss carryover by one dollar for each dollar of excluded canceled debt. Reduce the credit carryover by 33 $\frac{1}{3}$ cents for each dollar of excluded canceled debt.
7. **Foreign tax credit.** Reduce the credit carryover to or from 2007. Reduce the credit carryovers to 2007 in the order in which they are taken into account for 2007. Reduce the carryover by 33 $\frac{1}{3}$ cents for each dollar of excluded canceled debt.

Election to reduce the basis of depreciable property before reducing other tax attributes. You can elect to apply any portion of the tax attribute reduction required because of the exclusion of canceled debt to the reduction under section 1017 of the bases of depreciable property you held at the beginning of 2008. Basis of property is reduced in the following order:

1. Depreciable real property used in your trade or business or held for investment that secured the canceled debt.
2. Depreciable personal property used in your trade or business or held for investment that secured the canceled debt.
3. Other depreciable property used in your trade or business or held for investment.
4. Real property held primarily for sale to customers if you elect to treat it as if it were depreciable property on Form 982.

Basis reduction is limited to the total adjusted bases of all your depreciable property. Depreciable property for this purpose means any property subject to depreciation or amortization, but only if a reduction of basis will reduce the depreciation or amortization otherwise allowable for the period immediately following the basis reduction. If the amount of canceled debt excluded from income is more than the total bases in depreciable property, the excess is applied to reduce the other tax benefits in accordance with the general ordering rules for reduction of tax attributes described earlier under *Bankruptcy and Insolvency*. In figuring the limit on the basis reduction in (5), *Basis*, use the remaining adjusted bases of your properties after making this election. See Form 982 for information on how to

make this election. The election can be revoked only with the consent of the IRS.

Recapture of basis reductions. If you reduce the basis of property under these provisions and later sell or otherwise dispose of the property at a gain, the part of the gain due to this basis reduction is taxable as ordinary income under the depreciation recapture provisions. Treat any property that is not section 1245 or section 1250 property as section 1245 property. For section 1250 property, determine the depreciation adjustments that would have resulted under the straight line method as if there were no basis reduction for debt cancellation. See Publication 535, *Business Expenses*, or Publication 225, *Farmer's Tax Guide*, for more details on sections 1245 and 1250 property and the recapture of gain as ordinary income.

Qualified Farm Indebtedness

If you exclude canceled debt from income under both the insolvency exclusion and the exclusion for qualified farm indebtedness, you must reduce your tax attributes by the amount excluded under the insolvency exclusion before applying the exclusion for canceled qualified farm indebtedness. You must then reduce your remaining tax attributes (but not below zero) by the amount of canceled debt that qualifies for the farm debt exclusion.

Generally, when reducing your tax attributes for canceled qualified farm indebtedness excluded from income, you must follow the ordering rules for reduction of tax attributes, previously explained under *Bankruptcy and Insolvency*. However, do not follow the rules in item (5), *Basis*. Instead, only reduce the basis of qualified property. Qualified property is any property you use or hold for use in your trade or business or for the production of income. Reduce the basis of qualified property in the following order.

1. Depreciable qualified property. You can elect on Form 982 to treat real property held primarily for sale to customers as if it were depreciable property.
2. Land that is qualified property and is used or held for use in your farming business.
3. Other qualified property.

Qualified Real Property Business Indebtedness

If you make an election to exclude canceled qualified real property business debt from income, you must reduce the basis of your depreciable real property (but not below zero) by the amount of canceled qualified real property business debt excluded from income. The basis reduction is made at the beginning of 2008. However, if you dispose of your depreciable real property before the beginning of 2008, you must reduce the basis of the depreciable real property (but not below zero) immediately before the disposition. Enter the amount of the basis reduction on line 4 of Form 982.

Example 1. In 2002, Curt purchased a retail store for use in a business he operated as a sole proprietorship. Curt made a \$20,000 down payment and financed the remaining \$200,000 of

the purchase price with a bank loan. The bank loan was a recourse loan and was secured by the property. Curt used the property in his business continuously since its acquisition. Curt had no other debt secured by that depreciable real property. In addition to the retail store, Curt owned depreciable equipment and furniture with an adjusted basis of \$50,000. Curt's tax attributes included the basis of depreciable property, a net operating loss, and a capital loss carryover to 2007.

Curt's business encountered financial difficulties in 2007. On September 25, 2007, the bank financing the retail store loan entered into a workout agreement with Curt under which it canceled \$20,000 of the debt. Immediately before the bank entered into the workout agreement, Curt was insolvent to the extent of \$12,000. At that time, the outstanding principal balance on the retail store loan was \$185,000, the FMV of the store was \$165,000, and the adjusted basis was \$210,000 (\$220,000 cost minus \$10,000 accumulated depreciation). The bank sent Curt a 2007 Form 1099-C showing canceled debt of \$20,000 in box 2.

Curt must apply the insolvency exclusion before applying the exclusion for canceled qualified real property business indebtedness. Under the insolvency exclusion rules, Curt can exclude \$12,000 of the canceled debt from income. Curt elects to reduce his basis of depreciable property before reducing other tax attributes. Under that election, Curt must first reduce his basis in the depreciable real property used in his trade or business that secured the canceled debt. After the basis reduction, Curt's adjusted basis in the depreciable real property securing the canceled debt is \$198,000 (\$210,000 adjusted basis before entering into the workout agreement minus \$12,000 of canceled debt excluded from income under the insolvency exclusion).

The exclusion for qualified real property business indebtedness is limited to \$20,000, the excess of the outstanding principal amount of the qualified real property business indebtedness (immediately before the cancellation) over the FMV (immediately before the cancellation) of the real property securing such debt (\$185,000 minus \$165,000). Curt's exclusion is also limited to \$198,000, the total adjusted bases (determined after reduction for the canceled debt excluded under the insolvency exclusion) of his depreciable real property he held immediately before the cancellation. Since both of these limits exceed the \$8,000 of remaining canceled debt (\$20,000 minus \$12,000), Curt can exclude \$8,000 under the qualified real property business indebtedness exclusion.

Curt checks the boxes on lines 1b and 1d of Form 982. He completes Part II of Form 982 to reduce his bases in the depreciable real property by \$20,000, the amount of the canceled debt excluded from income. Curt enters \$8,000 on line 4 and \$12,000 on line 5.

Example 2. Bob owns depreciable real property used in his retail business. His adjusted basis in the property is \$145,000. The FMV of the property is \$120,000. The property is subject to \$134,000 of recourse debt which is secured by the property. Bob had no other debt secured by that depreciable real property. Bob also had a \$15,000 NOL in 2007.

During 2007, Bob entered into a workout agreement with the lender under which the

Table 1-1. Worksheet for Foreclosures and Repossessions

Keep for Your Records



Part 1. Figure your ordinary income from the cancellation of debt upon foreclosure or repossession. Complete this part only if you were personally liable for the debt. Otherwise, go to Part 2.	
1. Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	_____
2. Enter the fair market value of the transferred property	_____
3. Ordinary income from the cancellation of debt upon foreclosure or repossession.* Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	=====
Part 2. Figure your gain or loss from foreclosure or repossession.	
4. If you completed Part 1, enter the smaller of line 1 or line 2. If you did not complete Part 1, enter the amount of outstanding debt immediately before the transfer of property	_____
5. Enter any proceeds you received from the foreclosure sale	_____
6. Add line 4 and line 5	_____
7. Enter the adjusted basis of the transferred property	_____
8. Gain or loss from foreclosure or repossession. Subtract line 7 from line 6	=====

* The income may not be taxable. See Chapter 1, *Canceled Debts*, for more details.

lender canceled \$14,000 of the debt on the real property used in Bob's business. Immediately before the cancellation, Bob was insolvent to the extent of \$10,000. Bob excludes \$10,000 of the canceled debt from income under the insolvency exclusion. As a result of that exclusion, Bob reduced his NOL by \$10,000.

If Bob elects to apply the qualified real property business indebtedness exclusion provisions to the canceled debt, he can exclude the remaining \$4,000 of canceled debt from income under the exclusion for canceled qualified real property business indebtedness. The exclusion limit based on the excess of the outstanding principal amount of the qualified real property business debt (immediately before the cancellation) of the business real property securing such debt (\$134,000 minus \$120,000) and the exclusion limit that the amount of canceled qualified real property business debt that can be excluded from income cannot exceed the total adjusted bases (determined after any attribute reductions under Internal Revenue Code sections 108(b) and (g)) of depreciable property held immediately before the cancellation (at least \$145,000) both exceed the remaining \$4,000 of canceled debt.

Bob checks the boxes on lines 1b and 1d of Form 982 and enters \$14,000 on line 2. Bob completes Part II of Form 982 to reduce his basis of depreciable real property and his 2007 NOL by entering \$4,000 on line 4 and \$10,000 on line 6. None of the canceled debt is included in Bob's income.

2.

Foreclosures and Repossessions

If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale from which you may realize gain or loss. This is true even if you voluntarily return the property to the lender. If the outstanding loan balance was more than the FMV of the property and the lender cancels all or part of the remaining loan balance, you also may realize ordinary income from the cancellation of debt. You must report this income on your return unless certain exceptions or exclusions apply. See Chapter 1, *Canceled Debts*, for more details.

Borrower's gain or loss. You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized. For more information on figuring gain or loss from the sale of property, see *Gain or Loss From Sales and Exchanges*, in Publication 544, *Sales and Other Dispositions of Assets*.

TIP You can use Table 1-1 to figure your ordinary income from the cancellation of debt and your gain or loss from a foreclosure or repossession.

Amount realized and ordinary income on a recourse debt. If you are personally liable for the debt, the amount realized on the foreclosure or repossession includes the smaller of:

- The outstanding debt immediately before the transfer reduced by any amount for which you remain personally liable immediately after the transfer, or
- The FMV of the transferred property.

The amount realized also includes any proceeds you received from the foreclosure sale. If the FMV of the transferred property is less than the total outstanding debt immediately before the transfer reduced by any amount for which you remain personally liable immediately after the transfer, the difference is treated as ordinary income from the cancellation of debt. You must report this income on your return unless certain exceptions or exclusions apply. See Chapter 1, *Canceled Debts*, for more details.

Example 1. Tara bought a new car for \$15,000. She paid \$2,000 down and borrowed the remaining \$13,000 from the dealer's credit company. Tara is personally liable for the loan (recourse) and the car is pledged as security for the loan. On August 1, 2007, the credit company repossessed the car because Tara had stopped making loan payments. The balance due after taking into account the payments Tara made was \$10,000. The FMV of the car when it was repossessed was \$9,000. On November 15, 2007, the credit company forgave the remaining balance on the loan due to insufficient assets.

In this case, the amount Tara realizes is \$9,000. This is the smaller of:

- The \$9,000 difference between Tara's outstanding debt immediately before the repossession reduced by any amount for which she remains personally liable immediately after the repossession (\$10,000 minus \$1,000), or
- The \$9,000 FMV of the car.

Tara figures her gain or loss on the repossession by comparing the \$9,000 amount realized with her \$15,000 adjusted basis. She has a \$6,000 nondeductible loss. After the cancellation of the remaining balance on the loan in November, Tara also has ordinary income from cancellation of debt in the amount of \$1,000 (the remaining balance on the \$10,000 loan after the \$9,000 amount satisfied by the FMV of the repossessed car). Tara must report this \$1,000 on her return unless certain exceptions or exclusions apply.

Example 2. Lili paid \$200,000 for her home. She paid \$15,000 down and borrowed the remaining \$185,000 from a bank. Lili is personally liable for the loan and the house is pledged as security for the loan. In 2007, the bank foreclosed on the loan because Lili stopped making payments. When the bank foreclosed on the loan, the balance due was \$180,000, the FMV of the house was \$170,000, and Lili's adjusted basis was \$175,000 due to a casualty loss she had deducted. At the time of the foreclosure, the bank forgave \$2,000 of the \$10,000 debt in excess of the FMV (\$180,000 minus \$170,000). Lili remained personally liable for the \$8,000 balance.

In this case, Lili has ordinary income from the cancellation of debt in the amount of \$2,000. The \$2,000 income from the cancellation of debt is figured by subtracting the \$170,000 FMV of

the house from the \$172,000 difference between Lili's total outstanding debt immediately before the transfer of property reduced by the amount for which she remains personally liable immediately after the transfer (\$180,000 minus \$8,000)). Lili is able to exclude the \$2,000 of canceled debt from her income under the qualified principal residence indebtedness rules discussed earlier.

Lili must also determine her gain or loss from the foreclosure. In this case, the amount that Lili realizes is \$170,000. This is the smaller of: (a) the \$172,000 difference between Lili's outstanding debt immediately before the transfer reduced by any amount for which she remains personally liable immediately after the transfer (\$180,000 minus \$8,000) or (b) the \$170,000 FMV of the house. Lili figures her gain or loss on the foreclosure by comparing the \$170,000 amount realized with her \$175,000 adjusted basis. She has a \$5,000 nondeductible loss.

Amount realized on a nonrecourse debt. If you are not personally liable for repaying the debt secured by the transferred property, the amount you realize includes the full amount of the outstanding debt immediately before the transfer. This is true even if the FMV of the property is less than the outstanding debt immediately before the transfer.

Example 1. Tara bought a new car for \$15,000. She paid \$2,000 down and borrowed the remaining \$13,000 from the dealer's credit company. Tara is not personally liable for the loan (nonrecourse), but pledged the new car as security for the loan.

On August 1, 2007, the credit company repossessed the car because Tara had stopped making loan payments. The balance due after taking into account the payments Tara made was \$10,000. The FMV of the car when it was repossessed was \$9,000.

The amount Tara realized on the repossession is \$10,000. That is the outstanding amount of debt immediately before the repossession, even though the FMV of the car is less than \$10,000. Tara figures her gain or loss on the repossession by comparing the \$10,000 amount realized with her \$15,000 adjusted basis. Tara has a \$5,000 nondeductible loss.

Example 2. Lili paid \$200,000 for her home. She paid \$15,000 down and borrowed the remaining \$185,000 from a bank. Lili is not personally liable for the loan, but pledges the house as security.

The bank foreclosed on the loan because Lili stopped making payments. When the bank foreclosed on the loan, the balance due was \$180,000, the FMV of the house was \$170,000, and Lili's adjusted basis was \$175,000 due to a casualty loss she had deducted.

The amount Lili realized on the foreclosure is \$180,000, the outstanding debt immediately before the foreclosure. She figures her gain or loss by comparing the \$180,000 amount realized with her \$175,000 adjusted basis. Lili has a \$5,000 realized gain. See Publication 523, *Selling Your Home*, to figure and report any taxable amount.

Forms 1099-A and 1099-C. A lender who acquires an interest in your property in a foreclosure or repossession should send you Form 1099-A showing the information you need to

figure your gain or loss. However, if the lender also cancels part of your debt and must file Form 1099-C, the lender can include the information about the foreclosure or repossession on that form instead of on Form 1099-A. The lender must file Form 1099-C and send you a copy if the amount of debt canceled is \$600 or more and the lender is a financial institution, credit union, federal government agency, or any organization that has a significant trade or business of lending money. For foreclosures or repossessions occurring in 2007, these forms should have been sent to you by January 31, 2008.

3.

Abandonments

The abandonment of property is a disposition of property. You abandon property when you voluntarily and permanently give up possession and use of the property with the intention of ending your ownership but without passing it on to anyone else.

Loss from the abandonment of business or investment property is deductible as an ordinary loss, even if the property is a capital asset. The loss is the property's adjusted basis when abandoned. However, if the property is later foreclosed on or repossessed, gain or loss is figured as discussed earlier. The abandonment loss is deducted in the tax year in which the loss is sustained.

You cannot deduct any loss from abandonment of your home or other property held for personal use.

Example. In 2004, Anne purchased a home for \$200,000. In 2007, Anne lost her job and was unable to continue making her mortgage loan payments. Because her mortgage loan balance was \$185,000 and the FMV of her home was only \$150,000, Anne decided to abandon her home by permanently moving out on August 1, 2007. Anne has a nondeductible loss of \$200,000 (the adjusted basis). If the bank later forecloses on the loan or repossesses the house, she will have to figure her gain or nondeductible loss as discussed earlier in Chapter 2, *Foreclosures and Repossessions*.

Canceled debt. If the abandoned property secures a debt for which you are personally liable and the debt is canceled, you will realize ordinary income equal to the canceled debt. This income is separate from any loss realized from abandonment of the property. You must report this income on your return unless certain exceptions or exclusions apply. See Chapter 1, *Canceled Debts*, for more details.

Forms 1099-A and 1099-C. If you abandon property which secures a loan and the lender knows the property has been abandoned, the lender should send you Form 1099-A showing information you need to figure your loss from the abandonment. However, if your debt is canceled and the lender must file Form 1099-C, the lender

can include the information about the abandonment on that form instead of on Form 1099-A. The lender must file Form 1099-C and send you a copy if the amount of debt canceled is \$600 or more and the lender is a financial institution, credit union, federal government agency, or any organization that has a significant trade or business of lending money. For abandonments of property and debt cancellations occurring in 2007, these forms should have been sent to you by January 31, 2008.

4.

Detailed Examples

These examples use actual forms to help you prepare your income tax return. However, the information shown on the filled-in forms is not from any actual person or scenario.

Example 1—Mortgage loan modification.

In 2001, Nancy Oak purchased a principal residence for \$435,000. Nancy took out a \$420,000 mortgage loan to buy the principal residence and made a down payment of \$15,000. The loan was secured by the principal residence. The mortgage loan was a recourse debt, meaning that Nancy was personally liable for the debt. In 2002, Nancy took out a second mortgage loan (also a recourse debt) in the amount of \$30,000 that was used to substantially improve her kitchen.

In 2005, when the outstanding principal of the first and second mortgage loans was \$440,000, Nancy refinanced the two recourse loans into one recourse loan in the amount of \$475,000. The FMV of Nancy's principal residence at the time of the refinancing was \$500,000. Nancy used the additional \$35,000 debt (\$475,000 new mortgage loan minus \$440,000 outstanding principal of Nancy's first and second mortgage loans immediately before the refinancing) to pay off personal credit cards and to pay college tuition for her son. After the refinancing, Nancy has qualified principal residence indebtedness in the amount of \$440,000 because the refinanced debt is qualified principal residence indebtedness only to the extent the amount of debt does not exceed the amount of refinanced debt.

In 2007, Nancy was unable to make her mortgage loan payments. On August 31, 2007, when the outstanding balance of her refinanced mortgage loan was still \$475,000 and the FMV of the property was \$425,000, Nancy's bank agreed to a loan modification (a "workout") that resulted in a \$40,000 reduction in the principal balance of her loan. Nancy was neither insolvent nor in bankruptcy at the time of the cancellation.

Nancy received a 2007 Form 1099-C from her bank on January 31, 2008, showing canceled debt of \$40,000 in box 2. To determine if she must include the canceled debt in her income, Nancy must determine whether she

meets any of the exceptions or exclusions that apply to canceled debts. Nancy determines that the only exception or exclusion that applies to her is the qualified principal residence indebtedness exclusion.

Next, Nancy determines the amount, if any, of the \$40,000 of canceled debt that was qualified principal residence indebtedness. Although Nancy has \$440,000 of qualified principal residence indebtedness, part of her loan (\$35,000) was not qualified principal residence indebtedness because it was used to pay off personal

credit cards and college tuition for her son. Applying the ordering rule, the qualified principal residence indebtedness exclusion applies only to the extent the amount canceled exceeds the amount of the debt (immediately before the cancellation) that is **not** qualified principal residence indebtedness. Thus, Nancy can exclude only \$5,000 of the canceled debt as qualified principal residence indebtedness (\$40,000 amount canceled minus \$35,000 nonqualified debt).

Because Nancy does not meet any other exception or exclusion, Nancy checks only the

box on line 1e of Form 982 and enters \$5,000 on line 2. Nancy must also enter \$5,000 on line 10b and reduce the basis of her principal residence by the \$5,000 that she excluded from income, bringing the adjusted basis in her principal residence to \$460,000 (\$435,000 purchase price plus \$30,000 substantial improvement minus \$5,000). Nancy must also include the \$35,000 nonqualified debt portion in income on Form 1040, line 21.

Following are Nancy's sample forms.

CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code <i>Goodold Bank 54 Happy Street Anytown, DC 20002</i>		OMB No. 1545-1424 2007 Form 1099-C		Cancellation of Debt Copy B For Debtor <small>This is important tax information and is being furnished to the Internal Revenue Service. 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.</small>
CREDITOR'S federal identification number <i>10-6543210</i>	DEBTOR'S identification number <i>123-00-6789</i>	1 Date canceled <i>8-31-2007</i>	2 Amount of debt canceled \$ 40,000.00	
DEBTOR'S name <i>Nancy Oak</i>		3 Interest if included in box 2 \$	4	
Street address (including apt. no.) <i>360 Degree Circle</i>		5 Debt description <i>Home mortgage loan</i>		
City, state, and ZIP code <i>Anyplace, DC 20000</i>		6 Bankruptcy (if checked) <input type="checkbox"/>		7 Fair market value of property \$
Account number (see instructions)				

Form **1099-C**

(keep for your records)

Department of the Treasury - Internal Revenue Service

If you did not get a W-2, see page 19.	14	Other gains or (losses). Attach Form 4797	14		
	15a	IRA distributions	15a		
Enclose, but do not attach, any payment. Also, please use Form 1040-V.	16a	Pensions and annuities	16a		
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17		
	18	Farm income or (loss). Attach Schedule F	18		
	19	Unemployment compensation	19		
	20a	Social security benefits	20a		
	21	Other income. List type and amount (see page 24) <i>Cancellation of debt</i>	21	<i>35,000</i>	<i>00</i>
Adjusted Gross Income	22	Add the amounts in the far right column for lines 7 through 21. This is your total income ►	22		
	23	Educator expenses (see page 26)	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses. Attach Form 3903	26		
	27	One-half of self-employment tax. Attach Schedule SE	27		
	28	Self-employed SEP, SIMPLE, and qualified plans	28		

Form **1040** (2007)

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

OMB No. 1545-0046

Attachment
Sequence No. **94**

▶ **Attach this form to your income tax return.**

Name shown on return
Nancy Oak

Identifying number
123-00-6789

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
- 2** Total amount of discharged indebtedness excluded from gross income **2** 5,000.00
- 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:

4 For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4
5 That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5
6 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	6
7 Applied to reduce any general business credit carryover to or from the tax year of the discharge	7
8 Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8
9 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	9
10a 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>	10a
b Applied to reduce the basis of your principal residence. <i>Enter amount here ONLY if line 1e is checked</i>	10b 5,000.00
11 For a discharge of qualified farm indebtedness, applied to reduce the basis of:	
a Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5	11a
b Land used or held for use in a trade or business of farming	11b
c Other property used or held for use in a trade or business, or for the production of income	11c
12 Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12
13 Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13

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.

Example 2—Mortgage loan foreclosure. In 1999, John and Mary Elm purchased a principal residence for \$335,000. John and Mary took out a \$320,000 mortgage loan to buy the principal residence and made a down payment of \$15,000. The loan was secured by the principal residence and is a recourse debt, meaning John and Mary are personally liable for the debt.

John and Mary became unable to make their mortgage loan payments and on March 1, 2007, when the outstanding balance of the mortgage loan was \$315,000 and the FMV of the property was \$290,000, the bank foreclosed on the property and simultaneously canceled the remaining mortgage debt. Immediately before the foreclosure, John and Mary's only other assets and liabilities were a checking account with a balance of \$6,000, retirement savings of \$13,000, and credit card debt of \$5,500.

John and Mary received a 2007 Form 1099-C showing canceled debt of \$25,000 in box 2 (\$315,000 outstanding balance minus \$290,000 FMV) and a FMV of \$290,000 in box 7. In order to determine if John and Mary must include the canceled debt in income, they must

first determine whether they meet any of the exceptions or exclusions that apply to canceled debts. In this example, John and Mary meet both the insolvency and qualified principal residence indebtedness exclusions.

John and Mary were insolvent immediately before the cancellation because at that time their liabilities exceeded the FMV of their assets by \$11,500 (\$290,000 FMV of the personal residence plus \$6,000 checking account balance plus \$13,000 retirement savings minus \$315,000 balance on mortgage loan minus \$5,500 credit card debt). However, because the entire debt canceled is qualified principal residence indebtedness, the insolvency exclusion only applies if John and Mary elect to apply the insolvency exclusion instead of the qualified principal residence exclusion.

John and Mary do not elect to apply the insolvency exclusion instead of the qualified principal residence exclusion because under the insolvency exclusion their exclusion would be limited to the amount by which they were insolvent (\$11,500). Instead, John and Mary check

box 1e of Form 982 to exclude the canceled debt under the qualified principal residence exclusion. Under the qualified principal residence exclusion, the amount that John and Mary can exclude is not limited because their qualified principal residence indebtedness is not more than \$2 million and no portion of the loan was nonqualified debt. As a result, John and Mary enter the full \$25,000 of canceled debt on line 2 of Form 982. Because John and Mary no longer own the home due to the foreclosure, John and Mary have no remaining basis in their principal residence at the time of the debt cancellation. Thus, John and Mary leave line 10b of Form 982 blank.

John and Mary must also determine whether they have a gain or loss from the foreclosure. John and Mary complete Table 1-1 and find that they have a \$45,000 loss from the foreclosure. Because this loss relates to their personal residence, it is a nondeductible loss.

Following are John and Mary's sample forms and worksheet.

CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code Birch Bank 76 Spruce Lane Treetown, MD 20008		OMB No. 1545-1424		2007 Form 1099-C	Cancellation of Debt
CREDITOR'S federal identification number 10-7890123	DEBTOR'S identification number 234-00-7890	1 Date canceled 3-1-2007	2 Amount of debt canceled \$ 25,000.00		
DEBTOR'S name John and Mary Elm		3 Interest if included in box 2 \$	4	Copy B For Debtor This is important tax information and is being furnished to the Internal Revenue Service. 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.	
Street address (including apt. no.) 11 Siberian Street		5 Debt description Home mortgage loan			
City, state, and ZIP code Treetown, MD 20008		6 Bankruptcy (if checked) <input type="checkbox"/>			
Account number (see instructions) 505050		7 Fair market value of property \$ 290,000.00			
Form 1099-C		(keep for your records)		Department of the Treasury - Internal Revenue Service	

Table 1-1. Worksheet for Foreclosures and Repossessions (for John and Mary Elm)

Part 1. Figure your ordinary income from the cancellation of debt upon foreclosure or repossession. Complete this part only if you were personally liable for the debt. Otherwise, go to Part 2.	
1. Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	\$315,000.00
2. Enter the fair market value of the transferred property	\$290,000.00
3. Ordinary income from the cancellation of debt upon foreclosure or repossession.* Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	\$ 25,000.00
Part 2. Figure your gain or loss from foreclosure or repossession.	
4. If you completed Part 1, enter the smaller of line 1 or line 2. If you did not complete Part 1, enter the amount of outstanding debt immediately before the transfer of property	\$290,000.00
5. Enter any proceeds you received from the foreclosure sale	_____
6. Add line 4 and line 5	\$290,000.00
7. Enter the adjusted basis of the transferred property	\$335,000.00
8. Gain or loss from foreclosure or repossession. Subtract line 7 from line 6	(\$ 45,000.00)

* The income may not be taxable. See Chapter 1, *Canceled Debts*, for more details.

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

OMB No. 1545-0046

Attachment
 Sequence No. **94**

▶ Attach this form to your income tax return.

John and Mary Elm

Identifying number
 234-00-7890

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
- 2** Total amount of discharged indebtedness excluded from gross income. **2** 25,000.00
- 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:

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

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.

Example 3—Mortgage loan foreclosure with debt exceeding \$2 million limit. In 2005, Kathy and Frank Willow got married and entered into a contract with Hive Construction Corporation to build a house for \$3,000,000 to be used as their personal residence. Kathy and Frank took out a \$2,600,000 mortgage loan to build the home and put down the remaining \$400,000. Kathy and Frank are personally liable for the mortgage loan, which is secured by the principal residence.

In November 2007, when the outstanding principal balance on the mortgage loan was \$2,500,000, the FMV of the property fell to \$1,750,000 and Kathy and Frank abandoned the property by permanently moving out. The lender foreclosed on the property and, on December 3, 2007, sold the property to another buyer for \$1,750,000. On December 26, 2007, the lender canceled the remaining debt. Kathy and Frank have no tax attributes other than basis of personal use property.

The lender issued a 2007 Form 1099-C to Kathy and Frank showing canceled debt of \$750,000 in box 2 (the remaining balance on the \$2,500,000 mortgage debt after \$1,750,000 satisfaction through the foreclosure sale proceeds) and \$1,750,000 in box 7 (FMV of the property). Although Kathy and Frank abandoned the property, the lender did not need to also file a Form 1099-A because the lender canceled the debt in connection with the foreclosure in the same calendar year. Kathy and Frank are filing a joint return for 2007.

Because the foreclosure occurred prior to the debt cancellation, Kathy and Frank first calculate their gain or loss from the foreclosure of their principal residence using Table 1-1. Because Kathy and Frank still remained personally liable for the \$750,000 remaining debt after the foreclosure (\$2,500,000 outstanding debt immediately before the foreclosure minus \$1,750,000 satisfied through the sale of the residence securing the loan), Kathy and Frank enter \$1,750,000 on line 1 of Table 1-1 (\$2,500,000 outstanding debt immediately before the foreclosure minus the \$750,000 for which they remained liable). Completing Table 1-1, Kathy and Frank find that they have no ordinary income from the cancellation of debt upon foreclosure and that they have a \$1,250,000 loss. Because this loss relates to their personal residence, it is a nondeductible loss.

Because the lender later canceled the remaining amount of the debt, Kathy and Frank must also determine any taxable portion of their income from the cancellation of debt. Immediately before the cancellation, Kathy and Frank had \$15,000 in a savings account, \$17,000 in a retirement account, a car with a FMV of \$10,000,

and \$18,000 in credit card debt. The \$17,000 retirement account is made up of \$15,000 of deductible contributions and \$2,000 of nondeductible contributions. The car that Kathy and Frank owned at the time of cancellation had been fully paid off (so there was no related outstanding debt) and was originally purchased for \$16,000. Kathy and Frank had no adjustments to the cost basis of the car. Kathy and Frank had no other assets or liabilities at the time of the cancellation. Thus, immediately before the cancellation, Kathy and Frank had total liabilities of \$768,000 (\$750,000 remaining balance on mortgage loan plus \$18,000 in credit card debt) and total assets with a FMV of \$42,000 (\$15,000 in savings account plus \$17,000 in retirement account plus \$10,000 FMV of car). This means that immediately before the cancellation, Kathy and Frank were insolvent to the extent of \$726,000 (\$768,000 of total liabilities minus \$42,000 FMV of total assets).

At the beginning of 2008, Kathy and Frank had \$9,000 in their savings account, \$17,000 in their retirement account, and \$15,000 in credit card debt. Kathy and Frank also owned the same car at that time (still with a FMV of \$10,000 and basis of \$16,000). Kathy and Frank had no other assets or liabilities at that time. Kathy and Frank no longer own the home because the lender foreclosed on it in 2007.

The insolvency exclusion does not apply if the indebtedness is qualified principal residence indebtedness unless Kathy and Frank elect to apply the insolvency exclusion instead of the qualified principal residence indebtedness exclusion. The maximum amount that Kathy and Frank can treat as qualified principal residence indebtedness is \$2,000,000. The remaining \$500,000 (\$2,500,000 outstanding mortgage loan minus \$2,000,000 limit on qualified principal residence indebtedness) is **not** qualified principal residence indebtedness. Because only a part of the loan is qualified principal residence indebtedness, Kathy and Frank must apply the ordering rule to the canceled debt. Under the ordering rule, the qualified principal residence indebtedness exclusion applies only the extent that the amount canceled (\$750,000) exceeds the amount of the loan (immediately before the cancellation) that is **not** qualified principal residence indebtedness (\$500,000). This means that Kathy and Frank can only exclude \$250,000 (\$750,000 amount canceled minus \$500,000 nonqualified debt) under the qualified principal residence indebtedness exclusion.

Kathy and Frank do not elect to have the insolvency exclusion apply instead of the qualified principal residence exclusion. Nonetheless,

they can still apply the insolvency exclusion to the \$500,000 nonqualified debt because such debt is not qualified principal residence indebtedness. Kathy and Frank can exclude the remaining \$500,000 canceled debt under the insolvency exclusion because they were insolvent immediately before the cancellation to the extent of \$726,000. Thus, Kathy and Frank check the boxes on lines 1b and 1e of Form 982 and enter \$750,000 on line 2 (\$250,000 excluded under the qualified principal residence indebtedness exclusion plus \$500,000 excluded under the insolvency exclusion).

Next, Kathy and Frank reduce their tax attributes using Part II of Form 982. Because Kathy and Frank no longer own the home due to the foreclosure, Kathy and Frank have no remaining basis in their principal residence at the time of the debt cancellation. Thus, Kathy and Frank leave line 10b of Form 982 blank. However, Kathy and Frank are also excluding nonqualified debt under the insolvency exclusion. As a result, Kathy and Frank must reduce the basis of property they own based on the amount of canceled debt they are excluding from income under the insolvency rules. Because Kathy and Frank have no tax attributes other than basis of personal use property to reduce, Kathy and Frank figure the amount they must include on line 10a of Form 982 by taking the smallest of:

- The \$18,000 bases of their personal use property held at the beginning of 2008 (\$16,000 basis in the car plus \$2,000 basis in retirement account based on non-deductible contributions),
- The \$500,000 of the nonbusiness debt (other than qualified principal residence indebtedness) that they are excluding from income on line 2 of Form 982, or
- The \$30,000 excess of the total bases of the property and the amount of money they held immediately after the cancellation over their total liabilities immediately after the cancellation (\$15,000 in savings account plus \$17,000 in retirement account plus \$16,000 adjusted basis in car minus \$18,000 credit card debt).

Kathy and Frank enter \$18,000 on Form 982, line 10a and reduce their bases in the car and the retirement account to \$0.

Following are Kathy and Frank's sample forms and worksheet.

CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code Bumble Bank 5 Pollination Drive Buzztown, NJ 07000		OMB No. 1545-1424 2007 Form 1099-C		Cancellation of Debt Copy B For Debtor <small>This is important tax information and is being furnished to the Internal Revenue Service. 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.</small>
CREDITOR'S federal identification number 10-7654321	DEBTOR'S identification number 987-00-4321	1 Date canceled 12-26-2007	2 Amount of debt canceled \$ 750,000.00	
DEBTOR'S name Frank and Kathy Willow		3 Interest if included in box 2 \$	4	
Street address (including apt. no.) 21 Honeytree Lane, Apt. 5B City, state, and ZIP code Buzztown, NJ 07000		5 Debt description Home mortgage loan		
Account number (see instructions) 5551212		6 Bankruptcy (if checked) <input type="checkbox"/>	7 Fair market value of property \$ 1,750,000.00	

Form **1099-C** (keep for your records) Department of the Treasury - Internal Revenue Service

Table 1-1. Worksheet for Foreclosures and Repossessions (for Frank and Kathy Willow)

Part 1. Figure your ordinary income from the cancellation of debt upon foreclosure or repossession. Complete this part only if you were personally liable for the debt. Otherwise, go to Part 2.	
1. Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	\$1,750,000.00
2. Enter the fair market value of the transferred property	\$1,750,000.00
3. Ordinary income from the cancellation of debt upon foreclosure or repossession.* Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	<u>\$0.00</u>
Part 2. Figure your gain or loss from foreclosure or repossession.	
4. If you completed Part 1, enter the smaller of line 1 or line 2. (If you did not complete Part 1, enter the amount of outstanding debt immediately before the transfer of property.) Also include any proceeds you received from the foreclosure sale	\$1,750,000.00
5. Enter any proceeds you received from the foreclosure sale	\$1,750,000.00
6. Add line 4 and line 5	\$3,000,000.00
7. Enter the adjusted basis of the transferred property	\$3,000,000.00
8. Gain or loss from foreclosure or repossession. Subtract line 7 from line 6	<u>(\$1,250,000.00)</u>

* The income may not be taxable. See Chapter 1, *Canceled Debts*, for more details.

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

OMB No. 1545-0046

Attachment
 Sequence No. **94**

▶ Attach this form to your income tax return.

Name shown on return: Frank and Kathy Willow Identifying number: 987-00-4321

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
- 2 Total amount of discharged indebtedness excluded from gross income. 2 750,000.00
- 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:	
4 For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4
5 That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property.	5
6 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	6
7 Applied to reduce any general business credit carryover to or from the tax year of the discharge	7
8 Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8
9 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	9
10a 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>	10a 18,000.00
b Applied to reduce the basis of your principal residence. <i>Enter amount here ONLY if line 1e is checked</i>	10b
11 For a discharge of qualified farm indebtedness, applied to reduce the basis of: <ul style="list-style-type: none"> a 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 Land used or held for use in a trade or business of farming c Other property used or held for use in a trade or business, or for the production of income. 	11a 11b 11c
12 Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12
13 Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13

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.

5.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. The Taxpayer Advocate Service (TAS) is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

You can contact TAS by calling the TAS toll-free case intake line at 1-877-777-4778 or TTY/TDD 1-800-829-4059 to determine whether you are eligible for assistance. You can also call or write to your local taxpayer advocate, whose phone number and address are listed in your local telephone directory and in Publication 1546, Taxpayer Advocate Service – Your Voice at the IRS. You can file Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order), or ask an IRS employee to complete it on your behalf. For more information, go to www.irs.gov/advocate.

Low Income Taxpayer Clinics (LITCs). LITCs are independent organizations that provide low income taxpayers with representation in federal tax controversies with the IRS for free or for a nominal charge. The clinics also provide taxpayer education and outreach for taxpayers who speak English as a second language. Publication 4134, Low Income Taxpayer Clinic List, provides information on clinics in your area. It is available at www.irs.gov or your local IRS office.

Free tax services. To find out what services are available, get Publication 910, IRS Guide to Free Tax Services. It contains a list of free tax publications and describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.



Internet. You can access the IRS website at www.irs.gov 24 hours a day, 7 days a week to:

- **E-file** your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2007 refund. Click on *Where's My Refund*. Wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically).

Have your 2007 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.

- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the withholding calculator online at www.irs.gov/individuals.
- Determine if Form 6251 must be filed using our Alternative Minimum Tax (AMT) Assistant.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



Phone. Many services are available by phone.

- **Ordering forms, instructions, and publications.** Call 1-800-829-3676 to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
- **Asking tax questions.** Call the IRS with your tax questions at 1-800-829-1040.
- **Solving problems.** You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to www.irs.gov/localcontacts or look in the phone book under *United States Government, Internal Revenue Service*.
- **TTY/TDD equipment.** If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- **TeleTax topics.** Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- **Refund information.** To check the status of your 2007 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2007 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to listen in on or record random telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



Walk-in. Many products and services are available on a walk-in basis.

- **Products.** You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- **Services.** You can walk in to your local Taxpayer Assistance Center every business day for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you're more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary, but if you prefer, you can call your local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to www.irs.gov/localcontacts or look in the phone book under *United States Government, Internal Revenue Service*.



Mail. You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

Internal Revenue Service
1201 N. Mitsubishi Motorway
Bloomington, IL 61704-6613



CD/DVD for tax products. You can order Publication 1796, IRS Tax Products CD/DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Bonus: Historical Tax Products DVD - Ships with the final release.

- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- The CD which is released twice during the year.
 - The first release will ship the beginning of January 2008.
 - The final release will ship the beginning of March 2008.

Purchase the CD/DVD from National Technical Information Service (NTIS) at www.irs.gov/

cdorders for \$35 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD/DVD for \$35 (plus a \$5 handling fee). Price is subject to change.



CD for small businesses. Publication 3207, The Small Business Resource Guide CD for 2007, is a must for every small business owner or any taxpayer about to start a business. This year's CD includes:

- Helpful information, such as how to prepare a business plan, find financing for your business, and much more.
- All the business tax forms, instructions, and publications needed to successfully manage a business.
- Tax law changes for 2007.
- Tax Map: an electronic research tool and finding aid.

- Web links to various government agencies, business associations, and IRS organizations.
- "Rate the Product" survey—your opportunity to suggest changes for future editions.
- A site map of the CD to help you navigate the pages of the CD with ease.
- An interactive "Teens in Biz" module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

An updated version of this CD is available each year in early April. You can get a free copy by calling 1-800-829-3676 or by visiting www.irs.gov/smallbiz.



To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

<p>501(c)(3) organizations 4</p> <hr/> <p>A</p> <p>Abandonments 3, 10</p> <p> Canceled debt 10</p> <p>Assistance (See Tax help)</p> <hr/> <p>B</p> <p>Bankruptcy 4</p> <p> Reduction of tax attributes 7</p> <p>Business:</p> <p> Real property indebtedness 5</p> <hr/> <p>C</p> <p>Canceled debt:</p> <p> Exceptions 3</p> <p> Deductible debt 4</p> <p> Items otherwise excluded from income 3</p> <p> Price reduced after purchase 4</p> <p> Student loans 3</p> <p> Exclusions:</p> <p> Bankruptcy 4</p> <p> Hurricane Katrina 1</p> <p> Insolvency 4</p> <p> Qualified farm indebtedness 5</p> <p> Qualified principal residence indebtedness 1, 6</p> <p> Qualified real property business indebtedness 5</p> <p> Income from 3</p> <p> Repayment of 3</p> <p>Comments on publication 2</p>	<p>D</p> <p>Debts:</p> <p> Stockholder's 3</p> <p>Definitions:</p> <p> Adjusted tax attributes 5</p> <p> Principal residence 6</p> <p> Qualified acquisition indebtedness 5</p> <p> Qualified farm indebtedness 5</p> <p> Qualified principal residence indebtedness 6</p> <p> Qualified real property business indebtedness 5</p> <p>Discounts:</p> <p> Mortgage loan for early payment 3</p> <hr/> <p>E</p> <p>Educational loans 3</p> <hr/> <p>F</p> <p>Farm indebtedness 5</p> <p> Reduction of tax attributes 8</p> <p>Foreclosures 3, 9</p> <p>Form:</p> <p> 1099-A 10</p> <p> 1099-C 3, 10</p> <p>Free tax services 18</p> <hr/> <p>H</p> <p>Help (See Tax help)</p> <hr/> <p>I</p> <p>Income from canceled debt 3</p>	<p>Insolvency 4</p> <p> Reduction of tax attributes 7</p> <p>Interest:</p> <p> Canceled debt including 3</p> <hr/> <p>L</p> <p>Limits:</p> <p> Excluded farm debt 5</p> <p> Excluded principal residence indebtedness 6</p> <p> Qualified real property business indebtedness 6</p> <p>Loans (See also Mortgage) 3</p> <p> Student 3</p> <hr/> <p>M</p> <p>Missing children, photographs of 2</p> <p>More information (See Tax help)</p> <p>Mortgage:</p> <p> Discounted loan 3</p> <hr/> <p>P</p> <p>Principal residence indebtedness 6</p> <p>Publications (See Tax help)</p> <hr/> <p>Q</p> <p>Qualified farm indebtedness 5</p> <p> Reduction of tax attributes 8</p> <p>Qualified principal residence indebtedness 6</p> <p> Reduction of tax attributes 7</p>	<p>Qualified real property business indebtedness 5</p> <p> Reduction of tax attributes 8</p> <hr/> <p>R</p> <p>Real property business indebtedness 5</p> <p>Recapture:</p> <p> Basis reductions 8</p> <p>Repossessions 3, 9</p> <hr/> <p>S</p> <p>Sales or other dispositions 3</p> <p>Stockholder debts 3</p> <p>Student loans 3</p> <p>Suggestions for publication 2</p> <hr/> <p>T</p> <p>Tax attributes, reduction of:</p> <p> Bankruptcy 7</p> <p> Insolvency 7</p> <p> Qualified farm indebtedness 8</p> <p> Qualified principal residence indebtedness 7</p> <p> Qualified real property business indebtedness 8</p> <p>Tax help 18</p> <p>Taxpayer Advocate 18</p> <p>TTY/TDD information 18</p> <hr/> <p style="text-align: right;">■</p>
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