Insolvency exception to debt-forgiveness income can be tricky

In a special area on its Web site (in a Q&A on home foreclosure and debt cancellation), the Internal Revenue Service advised, "Insolvency can be fairly complex to determine and the assistance of a tax professional is recommended."

Also, in recognition of the important role that the "insolvency exception" plays in excluding a beleaguered home-owner's forgiveness-of-indebtedness income, the site further advised, "Consider the tax consequences before foreclosure." This article explores what planning can be done to maximize the use of the insolvency exception to reduce or eliminate forgiveness-of-indebtedness income for the individual caught in the current mortgage financing or similar credit squeeze.

The rules on income from debt forgiveness under Code Sec. 108 usually keep a low profile, quietly being applied without much controversy. Every so often, however, a crisis brings the rules front and center, and with them comes debate over their finer points. Many homeowners now in trouble as a result of mortgage resets and plummeting home values are hanging their hats on the Mortgage Indebtedness Relief Act (which was still pending at this article's deadline). However, even if it passes, many homeowners will not find relief under the new legislation, but should look to existing law and particularly to the insolvency exception in planning damage control.

Section 108(a)(1)(B) of the Internal Revenue Code of 1986, as amended (the "Code") provides that, "Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if … the discharge occurs when the taxpayer is insolvent." Code Section 108(d)(3) further provides that, "The term 'insolvent' means the excess of liabilities over the fair market

value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge."

WHEN TO MEAUSRE

A debtor who is insolvent immediately before the discharge realizes income to the extent that such discharge renders him solvent. The snapshot of assets less liabilities, therefore, must take place right before the mortgage lender forgives the debt. Timing, in this sense, is everything.

In planning to raise liabilities far enough above assets to cover any debt-forgiveness income, common sense usually provides sufficient guidance. If a relative seeks to give a gift to help the taxpayer rebuild their financial life, the gift should take place after the foreclosure sale or mortgage workout. Certain known expenses might be paid up front, such as tuition payments or insurance premiums, to reduce bank account balances. Anticipated tax liability on brokerage accounts because of trades and dividends should be paid in the form of estimated tax. Credit card workouts might be postponed until the next tax year to keep overall income in a lower bracket.

Fraudulent postponement of income, hiding of assets or acceleration of expenses, of course, will be disregarded in a closely examined liabilities-versus-assets computation. The standard audit techniques that an IRS examiner uses to track hidden income likely will be used as a matter of course if the insolvency exception is claimed.

WHAT TO MEAUSRE

All assets over all liabilities of the taxpayer are measured. For joint filers, this include the assets and liabilities of both spouses. If a mortgage and a home are only in the name of one spouse, filing separate returns can enable the couple to measure insolvency using the assets and liabilities of each spouse separately.

Non-recourse debt can only be considered up to the value of any underlying property on which it is encumbered. Liability in which the taxpayer is only a guarantor also generally does not count in determining insolvency. Nevertheless, facts may be shown that the chances of having to make good on the guarantee are significant, making such debt a factor in the insolvency computation.

The courts have generally held that a participant's account balances in tax-qualified plans cannot be reached by third-party creditors. Further, a participant's interest in a qualified plan generally is excluded from the bankruptcy estate and likewise should not be included in computing insolvency. The anti-alienation provision of Code Sec. 401(a) (13) generally protect those assets.

The issue of whether a pre-tax contribution for an existing year is allowed to count as an exempt asset if insolvency was otherwise predictable at eh time of contribution remains questionable. Showing a pattern of annual contributions at the same time may help.

HOW TO MEASURE

The burden of establishing that the insolvency exception applies is generally on the taxpayer. Within this task, valuation is a key component for determining insolvency. Unfortunately, a taxpayer who is close to insolvency generally doesn't have the resources to hire a full legal, accounting and valuation team to prove insolvency. Likely, such assessment is made later, when times are better, and frequently through an amended return.

In any case, the rule remains that the all-important snapshot of the net value of assets and liabilities is taken immediately before the forgiveness of indebtedness. Proof as to valuation must focus on that point in time.

AMOUNT OF FORGIVEN DEBT

Borrowers whose debt is reduced or eliminated receive a year-end statement, Form 1099-C, Cancellation of Debt, from their lender, who must also send a copy to the IRS. Form 1099-C must shoe the amount of debt canceled (Box 2) and the fair market value of property given up through foreclosure (Box 7).

The IRS urges borrowers to check the accuracy of their Form 1099-C and contact the lender about any errors, rather than the IRS. Rather than be the taxpayer's advocate in this regard, it is likely that the IRS will move on the nest step and access a deficiency bases on the Form 1099-C. The taxpayer needs to do this legwork.

CONCLUSION

The determination of insolvency can be fairly complex. Predictably, if the mortgage crisis grows, the IRS will develop prior-and future-year income comparisons, house value, loan amounts and other criteria to predict to whom its audit resources are most successfully applies when the insolvency exception is claimed.

Homeowners bordering on insolvency should make certain that they are insolvent and have proof to back up that determination before foreclosure or a mortgage workout.