

Recognizing the Tax Risks of Loan Modification

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You may recall that between 2007 and 2010, the United States experienced a subprime mortgage crisis that contributed to a world-wide financial recession that threatened to collapse our economy. In response, the federal government introduced and widely publicized several federal mortgage loan modification programs – each aimed at assisting distressed homeowners by modifying or refinancing mortgage loans that became unaffordable.



If you're unfamiliar with it, *loan modification* is the renegotiation of the terms of an existing loan. It may involve a reduction in principal or interest rate, an extension of the length of time for repayment, or a change in loan type (from adjustable rate to a fixed rate, for instance). It can also result in a *cancellation of debt (COD)* – a situation in which the total amount you

pay the lender is less than that required under the original agreement.

From the borrowers' perspective, a cancellation of debt is a great deal. The only drawback is that the Internal Revenue Service (IRS) is likely to treat the COD as taxable income, which can come as a nasty surprise when tax season hits. Unfortunately, it's likely to surprise more people this coming tax season because of the increase in loan modifications during the COVID-19 pandemic.

One of our responsibilities here at SWC is to protect our clients from nasty surprises. If you received a 1099-C from your lender or you've had a loan modified or are in the process of doing so, we want you to know what to expect and be prepared. One way to do that is by helping you answer common questions like the ones that appear below.

Is My Cancelled Debt Taxable? Answer These Four Questions

According to the IRS, "In general, if you have cancellation of debt income because your debt is canceled, forgiven, or discharged for less than the amount you must pay, the amount of the canceled debt is taxable, and you must report the canceled debt on your tax return for the year the cancellation occurs."

On its surface, that seems simple enough, but when you start digging into the details, determining whether a certain loan modification generated a taxable cancellation of debt (COD) can be challenging. If you renegotiated the terms of a loan, you can determine whether it resulted in taxable COD income by answering these four questions:

- Does the agreement with your lender constitute a loan modification?
- Is the loan modification *significant*?
- Does the modification result in COD income?
- Am I required to report my COD income?

Let's answer each of these questions.

Does the Agreement with Your Lender Constitute a Loan Modification?

A *loan modification* is an oral or written agreement to change your – or a lender's – rights or obligations under your original loan agreement. A loan agreement that contains one or more of the following changes qualifies as a loan modification:

- Deferral of interest payments
- Extension of the maturity date
- Interest rate change
- Cancellation or reduction of the loan balance
- *Subordination* of the debt (a legal agreement that prioritizes the payment of one debt over another)
- Changes to the collateral used to secure the loan

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- Change of borrower
- Change of recourse – whether you're personally liable for the debt (*recourse debt*) or not personally liable for it (*nonrecourse debt*)

If you're wondering which changes are *not* considered loan modifications, here are a few:

- A change in interest rate that's tied to an index (as with adjustable-rate mortgages).
- *Forbearance* (a lender's agreement to delay foreclosure) for two years or less. However, if payments are deferred along with forbearance, a modification (potentially significant) could occur.
- A failure on your part to make payments on the loan

Is the Loan Modification Significant?

Assuming something changed with your loan that constitutes a loan modification, the next step is to determine whether it's significant. A loan modification is considered significant when it meets one or more of the following conditions:

- The debt's annual yield after the change (such as a change in principal or interest rate) varies from the original yield by more than 25 basis points (one quarter of 1 percent) or more than 5 percent of the unmodified loan's annual yield.
- The timing of scheduled payments changes. For example, the lender extends the deadline for paying off the loan. This may or may not result in a significant modification. It generally depends on the length of the deferral, the amounts of the deferred payments, the length of time between modification and deferral, and whether deferred payments must be paid by the end of the safe-harbor period (within five years of the first deferred payment).
- Based on all the facts and circumstances, the legal rights are altered to a significant degree. Does that sound vague? It's supposed to be. In fact, it's referred to as the *catch-all rule*.

Does the Modification Result in COD (cancellation of debt) Income?

If the loan modification results in you paying your lender less than you would have under the previous loan agreement, the modification is likely to have resulted in a taxable cancellation of debt, and therefore should be reported.

If the amount canceled is considered a gift, bequest, or inheritance, it's not considered a taxable cancellation of debt. In addition, certain qualified student loans that are canceled under loan provisions that allow for the loan to be forgiven if you work for a certain period in certain professions, – such as those that encourage borrowers to provide health services in certain areas – are similarly not considered taxable cancellations of debt.

Likewise, the amount owned from student loans that are discharged due to death or total and permanent disability, and any *Pay-for-Performance Success Payments* that reduce the

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principal balance of your home mortgage under the Home Affordable Modification Program (HAMP), are not considered taxable cancellations of debt.

Finally, amounts of canceled debt that would be deductible if you (as a cash-basis taxpayer) paid them, and a qualified purchase price reduction given by the seller of property to the buyer, are also not considered taxable cancellations of debt.

Am I Required to Report My COD Income?

In some situations, you may receive cancellation of debt income that you're *not* required to report, such as the following situations:

- The debt was canceled in a Title 11 bankruptcy case
- The debt was canceled due to insolvency at the time of the loan modification
- Cancellation of qualified farm indebtedness
- Cancellation of qualified real property business indebtedness
- Cancellation of qualified principal residence indebtedness – discharged subject to an arrangement entered and evidenced in writing before Jan. 1, 2021

As you can see, determining if a loan agreement constitutes a loan modification – if it's significant, if it results in a cancellation of debt (COD), and if that COD is taxable – may require careful analysis and number crunching, along with a clear understanding of a lot of legal and accounting jargon. And at SWC, that's where we come in.

If you received a 1099-C from a lender or have negotiated a loan modification or are in the process of doing so, we can help. We can analyze your situation, advise you on whether your debt relief qualifies as COD income, estimate the taxes you can expect to pay on that amount, and help you plan your finances so that you're not unpleasantly surprised when tax season arrives.

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Keep in touch.

16875 W. Bernardo Drive, Suite. 290
San Diego, CA 92127
p: (858) 487-4580 | f: (858) 487-8033
w: www.SteesWalker.com
b: blog.SteesWalker.com

Laura A. Stees, CPA

Partner & Business Strategist
Laura@steeswalker.com

Marni L. Walker, CPA

Partner
Marni@steeswalker.com