

## PERSONAL INCOME TAX BULLETIN 2009-02

**Issued: April 30, 2009**  
**Reissued: December 17, 2021**

### Cancellation of Personal Indebtedness

#### I. Introduction.

This bulletin sets forth the tax consequences of cancellation of personal indebtedness. When a taxpayer borrows money, he or she is not required to include the loan proceeds in income because he or she has an obligation to repay the lender. When the amount of the obligation is subsequently forgiven, the amount you are forgiven is income because you no longer have an obligation to repay the lender. Cancellation is taxable income to the extent it represents a substitute for one of the eight classes of income. This bulletin describes instances in which cancellation of indebtedness is such a substitute.

The rules in this bulletin are general rules. The Department has published bulletins addressing other, specific types of personal indebtedness: for rules applying to cancellation of indebtedness secured by a principal residence, please refer to PIT Tax Bulletin 2009-03; for rules applying to cancellation of investment indebtedness, please refer to PIT Tax Bulletin 2009-05.

A taxpayer must not claim a loss for cancellation of indebtedness secured by personal property if the property relinquished has a basis greater than the amount of indebtedness cancelled. This is because personal property is not purchased with a profit motive.

#### II. How to use this bulletin.

1. Determine whether you have a personal indebtedness which has been cancelled, based on the definitions in Section III.
2. Refer to Section IV to determine whether the cancellation falls within one of the classes in income.
3. Refer to Section V to determine the amount of indebtedness which has been cancelled.
4. Refer to Section VI to determine whether an exception applies.
5. Please refer to Section VI for exceptions.

#### III. Definitions.

**Cancellation:** Cancellation occurs when a debtor is legally discharged from primary liability for an indebtedness and it is probable that the debtor will not be required to

make future payments as guarantor of the indebtedness. A debtor is legally discharged on the occurrence of one of the following identifiable events:

1. Discharge of indebtedness in bankruptcy.
2. Discharge of indebtedness in receivership.
3. Expiration of the statute of limitations for collecting the indebtedness.
4. Discharge of indebtedness arising from the creditor's election to pursue foreclosure which statutorily extinguishes its right to pursue further collection.
5. Extinguishment of indebtedness under a probate proceeding.
6. Discharge pursuant to an agreement between the creditor and debtor for less than full consideration.
7. Discharge according to a decision by the creditor, and under a defined policy of the creditor, to discontinue collection activity and to cancel the indebtedness.

A liability is not forgiven or discharged merely because it is temporarily uncollectible or unenforceable as a matter of fact. However, it is the position of the Department that, when a 36-month testing period during which there has been no payment made expires, the 36-month period provides a rebuttable presumption that the indebtedness has been discharged.

**Indebtedness:** An obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount. The term includes principal, interest, penalties, fines, and administrative fees.

**Personal indebtedness:** Any obligation **other than:**

1. An obligation incurred with respect to business or rents, royalties, patents or copyrights activity, or the proceeds of which are used for business or rents, royalties, patents or copyrights purposes.
2. An obligation secured wholly or in part by business or rents, royalties, patents or copyrights property; or,
3. An obligation for which a deduction or other offset against income was made for costs associated therewith; or,
4. An obligation to the extent it is included in the cost basis of business or rents, royalties, patents or copyrights property.

For an explanation of how the Pennsylvania personal income tax rules apply to cancellation of indebtedness secured by a principal residence, please refer to Personal Income Tax ("PIT") Bulletin 2009-3; for business indebtedness, see PIT Bulletin 2009-4; for investment indebtedness, please refer to PIT Bulletin 2009-5; for rents, royalties, patents or copyrights indebtedness, please refer to PIT Bulletin 2009-6.

#### **IV. Rules applicable to specific types of personal indebtedness.**

##### **A. Credit cards and other unsecured indebtedness.**

If your credit card company or bank writes off all or a portion of your credit card balance or unsecured indebtedness, you are not required to report the written-off amount on your PA-40 if the credit card or loan proceeds were used purely for personal purposes.

If the credit card or loan proceeds were used for personal and business purposes, you must report as income the written-off portion of your credit card balance to the extent that you deducted any interest as a business expense or to the extent you used the credit card to purchase items the cost of which you deducted from income. Please see Personal Income Tax Bulletin 2009-4 for specific rules governing mixed-use business loan proceeds.

You must report the cancellation of that portion of the credit card indebtedness as income if you used your credit card for unreimbursed business expenses deducted on Line 1b for the current tax year or a prior tax year. The cancelled amount must be reported as Gross Compensation on Line 1a of Form PA-40. A schedule should be submitted with the return identifying that the income is from the cancellation of credit card indebtedness used to pay unreimbursed expenses claimed in the current and/or prior tax year.

**Example:** A taxpayer has a credit card balance of \$10,000. Taxpayer incurred 50% of the balance for personal purchases, and 50% for business purchases. The credit card company agrees to cancel \$5,000 of the balance. One-half (\$2,500) of the cancellation is non-taxable because one-half of the entire balance was incurred for personal purposes. See Personal Income Tax Bulletin 2009-4 for guidance on reporting the income from the business portion of the cancelled indebtedness.

## **B. Student loans.**

If all or a portion of your student loans are paid for by a third party or cancelled, the payment or cancellation is taxable if it falls within one of Pennsylvania's eight classes of taxable income.

When a student provides services to someone who pays off some or all of the loan in exchange for the services, the loan payments are taxable to the student as compensation. Although such situations normally arise in the employer/employee context, an employer/employee relationship is not required for such payments to be taxable. All that is required is that the student provides services to the payor in exchange for the loan payments.

Cancellation of a student loan can also be taxable if the student provides services to the lender in exchange for the services. State and Federal programs exist that provide for the payment or cancellation of student loans when the student works for

a period of time in a specific profession.<sup>1</sup> Generally, such loan payments or cancellation are not subject to Pennsylvania personal income tax unless the student provides services directly to the payor or lender in exchange for the cancellation.

### **C. Personal use property.**

If all or a portion of a loan secured by personal use property is cancelled and the taxpayer gives up his ownership of the property, a taxpayer will realize net gain to the extent the cancelled amount exceeds his or her adjusted basis in the property. A taxpayer will realize gain when the taxpayer takes out a loan against the property for more than the purchase price. For example, this may have occurred if the taxpayer received rebates against the purchase price at the time of purchase or if the taxpayer simply incurred a loan for more than the purchase price and used the excess for other purposes.

If the taxpayer's adjusted basis is greater than the amount of indebtedness cancelled, taxpayer may not recognize a loss. A taxpayer can only recognize a loss when property is purchased with a profit motive.

**Example:** Taxpayer purchases a vehicle from his parents for \$10,000; this price reflects a discount from the vehicle's fair market value of \$15,000. His basis in the vehicle is \$10,000. The taxpayer borrows \$15,000 from the bank, using the vehicle as security for the loan. He uses \$10,000 of the loan proceeds to pay his parents for the vehicle. He uses the remaining \$5,000 to pay off his credit card, because the rate on his auto loan is lower than the interest rate on his credit cards.

After making payments of \$1,000 on the loan, the taxpayer defaults, the lender takes back the vehicle, and the lender cancels the auto loan. The amount realized is the \$14,000 of indebtedness cancelled (\$15,000 original balance - \$1,000 payments). He subtracts his \$10,000 basis in the vehicle from the amount cancelled, resulting in \$4,000 of Schedule D gain upon the disposition of his vehicle in the cancellation.

### **D. Cancellation in the employment context.**

If an employer lends money to an employee or subcontractor, cancellation of the indebtedness will result in compensation to the employee or subcontractor. If interest on the loan was capitalized, the taxpayer will also realize compensation to the extent the capitalized interest is cancelled.

If the employer is a lender in its ordinary course of business, the employee or subcontractor must report the cancellation as compensation if the employee's loan was on special terms unavailable to the general public. For example, if based on employee's credit score and other factors, the employee would have been ineligible to borrow

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<sup>1</sup>IRC § 108(f) provides an exemption from federal income tax for student loan cancellation under such programs in certain circumstances. Pennsylvania law does not contain similar provisions to IRC § 108(f).

money from the employer in its ordinary course of business then the loan was made on special terms unavailable to the general public. The employee in these circumstances must treat the cancellation of the loan as compensation.

**Example:** Employer lends employee \$50,000. If employer later cancels this indebtedness when the outstanding principal and interest is \$45,000, the employee must recognize compensation income of \$45,000.

## **V. Determining the amount to include in income.**

Indebtedness includes principal, interest, penalties, fines, and administrative fees. Please note that if a taxpayer received a Form 1099-C, the form may not include non-principal amounts which were cancelled, such as interest, penalties, fines, fees, and administrative costs. The taxpayer must add these non-principal amounts to the amount of cancelled principal to determine the total amount of cancelled indebtedness. Even if a taxpayer does not receive a Form 1099-C, he or she is required to report as income the amount of any cancelled indebtedness as required under the rules set forth in this bulletin.

If indebtedness is secured by personal property, the amount of income is equal to the amount of cancelled indebtedness minus the taxpayer's adjusted basis in any property relinquished in the transaction. The adjusted basis is the amount the taxpayer paid to purchase the property, including the cost of any permanent improvements made to the property after purchase. The taxpayer should not add recurring expenses which are not properly chargeable to the basis of the property.

## **VI. Exceptions.**

### **A. Disputed indebtedness.**

If the amount of indebtedness is genuinely in dispute, a settlement of a claim for less than the creditor seeks is not income if the debtor disputes the claim. This is because the amount payable is not a "fixed amount." Examples include:

1. Indebtedness which is not enforceable under state law;
2. Indebtedness settled for less than the face amount on account of a dispute between the lender and borrower. If a lender agrees to accept less than the face amount of an obligation because of the borrower's potentially meritorious claim arising from the lender charging usurious interest rates, the lender's agreement to cancel the borrower's liability for all accrued interest is not income because the amount of indebtedness is genuinely in dispute.

### **B. Cancellation of purchase-money indebtedness.**

If indebtedness arising in a sale on credit is cancelled or reduced, the amount cancelled is usually treated as an adjustment of the purchase price, to be applied in reduction of the buyer's adjusted basis for the property, rather than included in gross income as cancellation of indebtedness income.

An indebtedness reduction is treated as a reduction of purchase price, rather than indebtedness cancellation income, if:

- (1) The cancelled or reduced obligation is indebtedness of a purchaser of property to the seller of such property, arising out of the purchase of such property;
- (2) The taxpayer is not insolvent or in bankruptcy when the reduction occurs; and
- (3) The reduction would, apart from this rule, be cancellation of indebtedness income.

This rule applies only to reductions by agreement between buyer and seller and not, for example, to a cancellation resulting when an obligation is unenforceable on account of the running of the statute of limitations on enforcement.

This rule does not apply when the indebtedness has been transferred by the seller to a third party or when the property has been transferred by the buyer to a third party.

This rule does not apply if the indebtedness was never owed to the person from whom the taxpayer purchased the property. For example, if A buys a car from B, financing the purchase with a loan from C, the purchase-price reduction rule is inapplicable to any reduction of the liability.

**Example:** If a taxpayer purchases a personal use lawn tractor for \$5,000 on credit and the buyer refuses to pay because of a contract claim such as an alleged misrepresentation or breach of warranty, a settlement of the indebtedness for \$4,000 is non-taxable. Instead, this is treated as a retroactive reduction of the purchase price to \$4,000. The taxpayer must reduce his basis in the lawn tractor to \$4,000.