Title:
Debt Settlement & Income Taxes - What You Need To Know

Word Count:
554

Summary:
Debt settlement has become a popular approach to resolving problem debts without having to file bankruptcy. With this approach, creditors agree to accept a portion of what you owe (usually around 50% or less) to settle the account, and the remaining balance is forgiven. This technique will certainly continue to grow in popularity now that the new bankruptcy law makes it tougher to fully discharge debts in a Chapter 7 bankruptcy.

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Article Body:
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As with anything, there is no free lunch, and creditors are required to report canceled debts to the IRS on Form 1099 (when the canceled balance is $600 or greater). Therefore, the possibility exists that you may owe taxes on the forgiven portion of the debt. For this reason, many financial writers and debt counselors are strongly critical of debt settlement, to the point where they actually recommend against it just because you might end up owing taxes. But the tax consequences of settling your debts are greatly over-emphasized, and this is a really just a minor issue at best.

First, even if you end up owing taxes on the canceled balances, that's because you saved a bunch of money off your original debts. The total of what you paid the creditor, plus the taxes, will still be much less than what you owed to begin with. There is still a net savings. So it's hard to understand why this is viewed as a problem in the first place!

Second, the great majority of people who settle their debts are not required to pay taxes on the forgiven part of the balance. That's because of the "insolvency" rule, described in IRS Publication 908, "Bankruptcy Tax Guide." Don't let the title fool you. You don't need to have filed a formal declaration of bankruptcy to take advantage of the insolvency rule.

Basically, "insolvent" means that you have a negative net worth -- that is, you "owe" more than you "own." As a consequence, most debtors do not have a tax liability on the canceled debts, simply because most debtors are insolvent! It usually comes down to home equity. If you have enough equity in a home (or other property) to outweigh the total of your liabilities (debts), then you have a positive net worth, and will likely have to pay taxes on the forgiven debt amounts. However, the majority of people in serious debt trouble have a negative net worth, and are therefore insolvent. The way it works is that you can offset the canceled debt up to the amount by which you were insolvent at the time you did the settlement.

Come tax time, be sure to get professional tax advice specific to your situation. Also, be sure to read the section in IRS Publication 908 on "reduction of tax attributes," which requires people using the insolvency rule to reduce their basis in such things as rental property, loss carryovers, etc. Most of that probably won't apply to you, but again, get specific advice before winging it.

So, the message is, relax about paying taxes on canceled debt balances. That should be the least of your concerns if you're upside down financially. Don't let the misguided criticisms of financial writers (who haven't done their homework) discourage you from looking into one of the most popular and flexible options for achieving debt-freedom.