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OVERVIEW OF CANCELLATION OF DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX**In General**

The federal income tax treats the income that is derived from the cancellation of debt (COD) as a separate and distinct class of gross income. For Pennsylvania income tax purposes, COD income is not specifically mentioned in any of the eight classes of taxable income. However, the department has consistently taken the position that a COD is taxable when it represents a direct substitute for one of the eight classes of taxable income as provided for in the Tax Reform Code.

A cancellation of a genuine, uncontested and enforceable obligation for less than its face value can have varying Pennsylvania personal income tax effects, depending upon whether the debtor is insolvent after such discharge, the cancelled debt constitutes the unpaid balance of a purchase price or the discharge is ordered under the Bankruptcy Act. The effects may also vary depending upon the identity of the parties to the transaction and other factors. Accordingly, special Pennsylvania personal income tax rules apply when a debtor is legally discharged from primary liability for a debt and it is probable that the debtor will not be required to make future payments as guarantor of the debt.

When Cancellation of Debt Occurs

Indebtedness is cancelled only on the occurrence of an identifiable event indicating that the debt will never have to be repaid. Cancellation of debt generally occurs:

- Under Generally Accepted Accounting Principles (GAAP), the debt forgiven was considered a liability; or
- Where the debt forgiven constitutes a *quid pro quo* or incentive that would be taxable under Pennsylvania personal income tax law if it had been paid to the debtor in cash or in property.

Specific identifiable events indicating that the debt will never have to be repaid include:

- Discharge of indebtedness in bankruptcy;
- Discharge of indebtedness in receivership;
- Expiration of the statute of limitations for collecting the indebtedness;
- Cancellation of debt (COD) arising from the creditor's election to pursue foreclosure which statutorily extinguishes its right to pursue further collection;
- Extinguishment of a debt under a probate proceeding;
- Discharge pursuant to an agreement between the creditor and debtor for less than full consideration; and
- Discharge according to a decision by the creditor, and under a defined policy of the creditor, to discontinue collection activity and discharge the debt.

A liability is not forgiven or cancelled merely because it is temporarily uncollectible or unenforceable. 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 cancelled.

CLASSIFYING INCOME FROM CANCELLATION OF DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX**Classes of Income**

The Pennsylvania personal income tax statute does not conform to Internal Revenue Code Sections 61(a)(12) and 108. For Pennsylvania personal income tax purposes, taxpayers report taxable debt forgiveness in the class of income for which the debt was cancelled. The eight classes of income subject to Pennsylvania personal income tax are:

- Compensation;
- Interest;
- Dividends;
- Net Income (loss) from the operation of a business, profession or farm;
- Net gain (loss) from the sale, exchange or disposition of property;
- Net income (loss) from rents, royalties, patents and copyrights;

- Income from estates or trusts; and
- Gambling and lottery winnings.

If the COD relates to a personal, nonbusiness debt, such as personal credit card debt, then the COD is not taxable for Pennsylvania personal income tax purposes.

For more information regarding specific situations, please see the following:

- **Cancellation of Debt Incurred In Business, Profession or Farm Income**
If the debt forgiveness was related to business, profession or farm income in the past, then the income is reported in that class of income. For more information, refer to Personal Income Tax Bulletin 2009-04 - Cancellation of Business Indebtedness.
- **Cancellation of Debt Incurred in Rent and/or Royalty Business Activity**
Rent or royalty income can result if the taxpayer's indebtedness is cancelled and the indebtedness was incurred in the rent and/or royalty activity. For more information, refer to Personal Income Tax Bulletin 2009-06 - Cancellation of Rents, Royalties, Patents and Copyrights Indebtedness.
- **Cancellation of Debt Incurred in Investment Activity**
Interest or dividend income constitutes reportable income if the cancellation of debt resulted from the purchase of assets used in the investment activity. For more information, refer to Personal Income Tax Bulletin 2009-05 - Cancellation of Investment Indebtedness.
- **Cancellation of Debt Incurred in Compensation Income**
Compensation income constitutes reportable income if the indebtedness is cancelled in exchange for services rendered or relates to an employee/employer relationship. For more information, refer to Personal Income Tax Bulletin 2009-02 - Cancellation of Personal Indebtedness.
- **Cancellation of Debt Incurred to Obtain Rental Real Estate**
If the cancellation of debt relates to a loan obtained to acquire rental real estate, it is reported on PA Schedule D as gain on the sale of property. See *Wirth, et al. v. Commonwealth*, 95 A.3d 822 (Pa. 2014) (holding that cancellation of indebtedness is taxable under the Commonwealth's personal income tax).
- **Cancellation of Debt Incurred as 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. 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. 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. For more information, refer to Personal Income Tax Bulletin 2009-02 – Cancellation of Personal Indebtedness.

PENNSYLVANIA PERSONAL INCOME TAX INSOLVENCY PROVISION

Solvent Taxpayer

If the taxpayer is solvent, the amount of indebtedness is generally reported as income. Solvent taxpayers would report the amount of indebtedness forgiven or discharged with the associated class of income.

Insolvent Taxpayer

Insolvent taxpayers not filing for bankruptcy recognize cancellation of debt as income. The reportable amount is the lesser of:

- The amount of indebtedness forgiven or discharged; or
- The excess over the taxpayer's fair market value of assets (net worth) immediately after the cancellation.

If an insolvent taxpayer is not rendered solvent by the cancellation of debt, no income is recognized.

Basis Adjustment

The basis of an insolvent debtor's property must be reduced but not below its fair market value (FMV). Basis reductions for amounts cancelled shall be allocated in any manner that has the effect of reducing the difference between the fair market value and the adjusted basis of the properties. Requisite basis adjustments are required to the extent that income was not reported as a result of the Pennsylvania personal income tax insolvency provision.

PASS-THROUGH ENTITIES**Pennsylvania Personal Income Tax Insolvency Provision**

- **Application to partnerships and PA S corporations**
 - Applied at the partner level
 - Applied at the PA S corporation level
- **Insolvency is determined immediately before the transaction**
 - At the partner level to determine whether that partner is insolvent immediately before the cancellation of indebtedness transaction.
 - At the PA S corporation level to determine whether that PA S corporation is insolvent immediately before the cancellation of indebtedness transaction.
- **Recognition of Reportable Income for Pennsylvania Personal Income Tax**

Recognition of reportable income for Pennsylvania personal income tax purposes to the extent that:

 - The partner is made solvent as a result of the transaction
 - The PA S corporation is solvent as a result of the transaction
- **Required Basis Adjustment Relating to Cancellation of Debt Not Reported for Pennsylvania Personal Income Tax**

Required basis adjustment relating to cancellation of debt transaction not reported for Pennsylvania personal income tax purposes:

 - First reducing the insolvent partner's Pennsylvania personal income tax adjusted basis in the entity. Any excess requires applicable adjustment at the partnership level for partner's percentage share of assets.
 - Reducing PA S corporation Pennsylvania personal income tax adjusted basis in its assets.

TREATMENT OF CANCELLATION OF INDEBTEDNESS OF RECOURSE DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX**No Bifurcation for Pennsylvania Personal Income Tax**

There is no required bifurcation between PA Schedule D gain and other Pennsylvania personal income tax reportable income for Pennsylvania personal income tax purposes.

For federal income tax purposes, a bifurcation is required based on the relationship between fair market value of the property and adjusted basis. If the collateral encumbered by recourse debt is transferred, foreclosed or abandoned to the creditor, then the gain is reported on PA Schedule D.

Net Profit (Loss) From a Business, Profession or Farm

If the collateral is not transferred, foreclosed or abandoned, but the indebtedness is reduced, business income generally occurs if the debt was incurred in the business activity. For more information, refer to Personal Income Tax Bulletin 2009-04 - Cancellation of Business Indebtedness.

Rental or Royalty Business Income or Losses

If the collateral is not transferred but the indebtedness is reduced, rental or royalty income generally occurs if the debt was incurred in the rental or royalty activity. For more information, refer to Personal Income Tax Bulletin 2009-06 - Cancellation of Rents, Royalties, Patents and Copyrights Indebtedness.

Cancellation of Recourse Debt for Solvent Debtor with Seller Purchase Price Reduction

The cancellation of recourse debt for a solvent debtor associated with a purchase price reduction by the seller does not constitute reportable income for Pennsylvania personal income tax purposes. Rather, Pennsylvania personal income tax basis in the property is reduced as a result of the purchase price reduction.

Cancellation of Recourse Debt that is Personal in Nature is not Reportable Income for Pennsylvania Personal Income Tax

The cancellation of recourse debt that is personal in nature does not constitute reportable income for Pennsylvania personal income tax purposes.

TREATMENT OF CANCELLATION OF INDEBTEDNESS OF NONRECOURSE DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX

Pennsylvania Personal Income Tax Schedule D Gain on Pennsylvania Personal Income Tax Reportable Cancellation of Debt

- **Calculating Pennsylvania Personal Income Tax Schedule D Gain If Property Is Transferred to Lender or Foreclosed By Lender**

Collateral transferred, foreclosed or abandoned in exchange for cancellation of debt is always treated as Pennsylvania Schedule D gain and not business income, rental or royalty income or as interest and/or dividend income. The Pennsylvania Schedule D gain is calculated as follows:

Adjusted issue amount of the debt
Pennsylvania personal income tax adjusted basis
Pennsylvania Schedule D gain

- **Collateral Is Not Transferred for Net Profit (Loss) From a Business, Profession or Farm**
If the collateral is not transferred, foreclosed or abandoned, business income generally occurs if the debt proceeds were incurred in a business activity. For more information, refer to Personal Income Tax Bulletin 2009-04 - Cancellation of Business Indebtedness.
- **Collateral Is Not Transferred for Rental or Royalty Business Income (Loss)**
If the collateral is not transferred, foreclosed or abandoned, then rental or royalty income generally occurs if the debt proceeds were incurred in the rental or royalty activity. For more information, refer to Personal Income Tax Bulletin 2009-06 - Cancellation of Rents, Royalties, Patents and Copyrights Indebtedness.
- **Constructive Cash Distributions Pass Through to Owners**
The treatment of nonrecourse debt discharged in a Title 11 Bankruptcy proceeding is governed by the bankruptcy Code Section 346.
- **Nonrecourse Debt Discharged By Seller in a Purchase Price Reduction**
The discharge of indebtedness of nonrecourse debt by a seller in a purchase price reduction for a solvent debtor is determined under the Pennsylvania personal income tax purchase price reduction provisions.
- **Discharge of Personal Nonrecourse Debt Is Not Reportable Income for Pennsylvania Personal Income Tax**
The discharge of nonrecourse indebtedness that is personal in nature does not constitute reportable income for Pennsylvania personal income tax purposes.
- **Discharge of Investment Activity Nonrecourse Debt Is Reportable as Interest or Dividend Income for Pennsylvania Personal Income Tax**
The discharge of nonrecourse indebtedness associated with an investment activity where the funds were

used to purchase assets generating interest and dividend income, constitutes reportable interest or dividend income for Pennsylvania personal income tax purposes.

PENNSYLVANIA PERSONAL INCOME TAX APPLICATION TO PA S CORPORATION SHAREHOLDERS WITH A CANCELLATION OF DEBT

For Pennsylvania Personal Income Tax, Cancellation of Debt Is Also Determined at PA S Corporation Shareholder Level

For Pennsylvania personal income tax purposes, a cancellation of indebtedness for PA S corporation shareholders is treated as follows:

- Under Title 11 Bankruptcy – The Bankruptcy Code provisions are applicable as they apply to PA S corporations;
 - Not taxable to the extent the PA S corporation is still insolvent immediately after the discharge. The determination of insolvency is based on Pennsylvania law;
 - The PA S corporation must be insolvent before the transaction;
 - Not taxable to the extent the cancellation of debt relates to a purchase price reduction made by the seller for a solvent PA S corporation;
 - Generally taxable to the extent the debt was incurred:
 - in a business activity (net profit from a business, profession or farm);
 - in a rental or royalty activity;
 - in an investment activity where funds were borrowed to purchase portfolio assets used in an investment activity.
- Note: An investment activity is not a commercial activity.
- Not taxable to the extent that the debt discharge relates to personal debt including student loans.
 - Taxable to the extent the debt forgiven was exchanged for compensation.
 - If the debt forgiveness was related to business, profession or farm income in the past, then the income is reported in that class of income. For more information, refer to Personal Income Tax Bulletin 2009-04 - Cancellation of Business Indebtedness.

Discharge of Debt by PA S Corporation Employee or Subcontractor is Included in Compensation

If the PA S corporation cancels an employee's or subcontractor's outstanding loan amount, then the amount of the cancellation is included in the employee's or subcontractor's compensation.

Classify Accrued but Unpaid Expenses to Arrive at Reportable Income of a PA S Corporation for Pennsylvania Personal Income Tax

Accrued but unpaid expenses are recorded as income in the respective class of income where the accrued expense was taken in arriving at reportable income for Pennsylvania personal income tax purposes.

BANKRUPTCY

Individuals filing for Bankruptcy

Unless the case is dismissed, no income shall be considered to have been realized by reason of discharge of indebtedness under bankruptcy laws. The Bankruptcy Code and Internal Revenue Code of 1986, 26 U.S.C. § 1, *et seq.*, provide specific rules that must be followed for state and local tax purpose. For information on how to file a tax return for a bankruptcy estate, refer to PA Personal Income Tax Guide - Estates, Trusts, and Decedents.

NOTE: This guide is not intended to cover bankruptcy law in general, or to provide a detailed discussion of the tax implications of bankruptcy. If you file for bankruptcy and have tax questions, you should seek professional advice.

Special Rules for State and Local Taxes

Section 346 of the Bankruptcy Code, 11 U.S.C. § 346, provides special rules for the treatment of state and local taxes in a bankruptcy. An individual bankruptcy filed under Chapters 7 or 11 of the Bankruptcy Code leads to the creation of a bankruptcy estate for federal and Pennsylvania tax purposes. The trustee of the estate is responsible for filing a Pennsylvania fiduciary tax return (Form PA-41), reporting all of the estate's income, gain, loss, deductions, and credits.

The tax period of a debtor in bankruptcy is determined under federal law. In addition, the bankruptcy estate uses the same accounting method as the debtor use immediately prior to filing the bankruptcy. Transfers of property between the debtor and the state are not treated as a disposition of property, except to the extent the transfer is a disposition under the Internal Revenue Code. The bankruptcy estate's trustee is responsible for withholding tax on any payments subject to withholding under Pennsylvania law.

The bankruptcy estate succeeds to any Pennsylvania tax attributes of the debtor, and after a bankruptcy case is closed or dismissed, the debtor succeeds to any tax attributes to which the estate succeeded.

Taxable income is not realized by the bankruptcy estate, debtor a successor of the debtor by reason of COD in a chapter 7 or 11 bankruptcy, to the extent the COD is not taxed for federal tax purposes.

Reduction of Tax Attributes under Internal Revenue Code Section 108(b)

If a debtor excludes cancelled debt from income because it is cancelled in a bankruptcy case, he or she must use the excluded amount to reduce certain "tax attributes." Tax attributes include the basis of certain assets, as well as certain losses and credits. By reducing these tax attributes, tax on the cancelled debt is in part postponed instead of being entirely forgiven. This prevents an excessive tax benefit from the debt cancellation.

If a separate bankruptcy estate was created, the trustee or debtor-in-possession must reduce the estate's attributes (but not below zero) by the cancelled debt.

For Pennsylvania tax purposes, a debtor or estate must reduce their Pennsylvania tax attributes in a similar manner as their federal tax attributes are reduced. Pennsylvania follows the rule of Section 108(b) of the Internal Revenue Code, to the extent that Pennsylvania allows for a similar tax attribute.