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JULY 2012

Cancelled debt can result in taxable income

With the recent economic downturn experienced by many taxpayers, there is a tax concept that is very important: cancellation of debt. You would think that the cancellation of debt by a credit card company or mortgage company would be a good thing for the taxpayer. And it can be, but it can also be considered taxable income by the IRS. Here is a quick review of various debt cancellation situations.

- **Consumer debt.** If you have gone through some type of credit “workout” program on consumer debt, it’s likely that some of your debt has been cancelled. If that is the case, be prepared to receive IRS Form 1099-C representing the amount of debt cancelled. The IRS considers that amount taxable income to you, and they expect to see it reported on your tax return. The exception is if you file for bankruptcy. With bankruptcy, generally the debt cancelled is not taxable.

Even if you are not legally bankrupt, you might be technically insolvent (where your liabilities exceed your assets). If this is the case, you can exclude your debt cancellation income by reporting your financial condition and filing IRS Form 982 with your tax return.

- **Primary home.** If your home is “short” sold or foreclosed and the lender receives less than the total amount of the outstanding loan, you can also expect that amount of debt cancellation to be reported to you and the IRS. But special rules allow you to exclude up to \$2 million in cancellation income in many circumstances. You will again need to complete IRS Form 982, but the exclusion from taxable income brought about by the debt cancellation on your primary residence is incredibly liberal. So make sure to take advantage of these rules should they apply to you.

- **Second home, rental property, investment property, business property.** The rules for debt cancellation on second homes, rental property, and investment or business property can be extremely complicated. Generally speaking, the new laws that cover debt cancellation don’t apply to these properties, and the IRS considers any debt cancellation income taxable. Nevertheless, given your cost of these properties, your financial condition, and the amount of debt cancelled, it’s still possible to have this debt cancellation income taxed at a preferred capital gains rate, or even considered not taxable at all.

Be aware that many of the special debt cancellation provisions are set to expire at the end of 2012. If you’re unsure as to how debt cancellation affects you, contact our office to review your situation and determine how much, if any, cancelled debt will be taxable income to you.

What to consider in making the social security decision

If you’re approaching retirement and are eligible for social security, you have three broad options for drawing your benefits: start early, wait until your “full” retirement age, or hold out a few years longer to qualify for the monthly maximum.

- **Early withdrawals.** Starting your withdrawals at the earliest allowable date (age 62) may be a good idea if you (a) plan to stop working or cut back to part-time status, and (b) really need the income.

Your health is also a consideration, since an early start will maximize your lifetime benefits if your life expectancy is much below eighty.

Selecting early retirement will permanently reduce the amount you receive each month. In addition, until you reach full retirement age, your benefits will be cut by one dollar for every two dollars over \$14,640 that you earn (as of 2012). Consequently, if you're in good health, don't need the extra income, and/or plan to keep on working, you're generally better off postponing your benefits until full retirement age or beyond.

- **Full retirement age.** Full retirement age is 66 for workers born between January 1, 1943, and December 31, 1954. For those born later, the age limit gradually increases to 67.

Once you've reached full retirement age, your social security benefits are no longer reduced by any amount of earned income. If you've waited to start your benefits, your monthly income will be greater than under early retirement, although less than you'd get by waiting until age seventy.

- **Maximum retirement age.** If you wait until age 70 to begin drawing social security, your monthly benefits will be maximized for the rest of your life. This option is generally the best choice for people who are in good health and who can afford to wait. The disadvantage is that political factors might cause changes to the program in the interim.

- **Other factors.** Although the above three ages are the major milestones, the years between are also important, since each year you wait will increase your monthly benefit. If you're now working for a relatively high income, your overall benefits will increase even more because they're recomputed annually based on your highest earning years.

Other considerations include your marital status, the relative ages and earnings of each spouse, and expected survivor benefits. The potential variables are too complex to address here, but if you're interested in planning for your own retirement, just call our office to schedule an appointment.

Quick Quiz: Taxable income or nontaxable?

You only have to examine your paycheck to realize certain income is tax-free. For example, health insurance premiums paid by your employer are generally not includible in your income.

Do you know the tax status of other types of income? Here's a short quiz to test your knowledge.

1. You tell your son he'll be the sole beneficiary of your estate, and that you've decided to give him an advance on his inheritance. You hand him a check for \$10,000. He wants to know how much he'll have to pay in taxes. What do you tell him?

Answer: Gifts, bequests, devises, and inheritances are generally not taxable to the beneficiary. Income produced from those sources is taxable to the beneficiary.

2. You withdraw \$20,000 of the contributions you made to your Roth IRA over the past five years, but you're not of retirement age. Do you have a taxable event?

Answer: Unlike traditional IRAs, distributions from Roths are first allocated to amounts you contributed to the account. To the extent the distribution is a return of your contributions, it's not included in your income and you can withdraw it penalty- and tax-free.

Tax filing reminder: July 31 is the deadline for filing 2011 retirement or employee benefit returns (5500 series) for plans on a calendar year.