Gain or Loss on Disposition

If a debt for which the taxpayer is personally liable is discharged as a result of a foreclosure, sale, or other disposition of property that secures the debt, the taxpayer may realize gain or loss on the disposition as well as COD income.

In the case of personal use property, such as a principal residence, any loss would be nondeductible.
Deductible Debt

Section 108(e)(2) provides that no COD income is realized to the extent that payment of the debt would have given rise to a deduction.

– Mortgage interest is generally deductible under section 163(h)(3).

– Interest on other types of consumer debt (e.g., credit card debt, automobile financing) generally is nondeductible personal interest under section 163(h)(2).
Workouts

COD income can arise in a debt “workout” as well as in a foreclosure.

Whether this COD income is taxable depends on whether an exception in section 108 applies.
Section 108 excludes discharges of indebtedness from gross income if:

• The discharge occurs in bankruptcy
• The discharge occurs when the taxpayer is insolvent
• The debt is “qualified farm indebtedness”
• The debt is a student loan for which the exclusion provided by section 108(f) applies
• The debt is “qualified principal residence indebtedness”
The Mortgage Forgiveness Debt Relief Act of 2007
(Pub. Law 110-142)

• Created a new exclusion under sections 108(a)(1)(E) and 108(h) for discharged qualified principal residence indebtedness.

• Applies to qualified principal residence indebtedness that is discharged on or after Jan. 1, 2007 and before Jan. 1, 2010.