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employees are considered public employees under state law, or

3. An educational institution (defined later):

   a. Under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan, or

   b. As part of a program of the institution designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization (defined later).

A loan to refinance a qualified student loan also will qualify if it was made by an educational institution or a tax-exempt section 501(a) organization under its program designed as described in (3)(b) above.

Exception. You have ordinary income from the cancellation of debt if your student loan was made by an educational institution and is canceled because of services you performed for the institution or other organization that provided the funds. You must include this income on your return unless other exceptions or exclusions apply.

Education loan repayment assistance. Education loan repayments made to you by the National Health Service Corps Loan Repayment Program or a state education loan repayment program eligible for funds under the Public Health Service Act are not taxable if you agree to provide primary health services in health professional shortage areas.

Educational institution. An educational institution is an organization with a regular faculty and curriculum and a regularly enrolled body of students in attendance at the place where the educational activities are carried on.

Section 501(c)(3) organization. A section 501(c)(3) organization is any corporation, community chest, fund, or foundation organized and operated exclusively for one or more of the following purposes.

- Charitable.
- Educational.
- Fostering national or international amateur sports competition (but only if none of the organization's activities involve providing athletic facilities or equipment).
- Literary.
- Preventing cruelty to children or animals.
- Religious.
- Scientific.
- Testing for public safety.

Deductible Debt

If you use the cash method of accounting, you do not realize income from the cancellation of debt if the payment of the debt would have been a deductible expense. This exception applies before the price reduction exception discussed below.

Example. You get accounting services for your farm on credit. Later, you have trouble paying your farm debts and your accountant forgives part of the amount you owe for the accounting services. How you treat the canceled debt depends on your method of accounting.

- Cash method. You do not include the canceled debt in income because payment of the debt would have been deductible as a business expense.
- Accrual method. Unless another exception or exclusion applies, you must include the canceled debt in ordinary income because the expense was deductible when you incurred the debt.

Price Reduced After Purchase

If debt you owe the seller for the purchase of property is reduced by the seller at a time when you are not insolvent and the reduction does not occur in a title 11 bankruptcy case, the reduction does not result in cancellation of debt income. However, you must reduce your basis in the property by the amount of the reduction of your debt to the seller. The rules that apply to bankruptcy and insolvency are explained in the next section, *Exclusions*.

Exclusions

There are several exclusions from the general rule of inclusion of canceled debt in income. These are explained next. Generally, if you exclude canceled debt from income under one of these provisions, you must also reduce your tax attributes (certain credits, losses, and basis of assets) as explained later under *Reduction of Tax Attributes*.

Bankruptcy

Debt canceled in a title 11 bankruptcy case is not included in your income. A title 11 bankruptcy case is a case under title 11 of the United States Code, but only if the debtor is under the jurisdiction of the court and the cancellation of the debt is granted by the court or occurs as a result of a plan approved by the court.

How to report the bankruptcy exclusion. To show that your debt was canceled in a bankruptcy case and is excluded from income, attach Form 982 to your federal income tax return and check the box on line 1a. Lines 1b through 1e do not apply to a cancellation that occurs in a title 11 bankruptcy case. Enter the total amount of debt canceled in your title 11 bankruptcy case on line 2. You must also reduce your tax attributes in Part II of Form 982 as explained under *Reduction of Tax Attributes*, later.

Insolvency

Do not include a canceled debt in income to the extent that you were insolvent immediately before the cancellation. You were insolvent immediately before the cancellation to the extent that the total of all of your liabilities exceeded the FMV of all of your assets immediately before the cancellation. For purposes of determining insolvency, assets include the value of everything you own (including assets that serve as collateral for debt and exempt assets which are beyond the reach of your creditors under the law, such as your interest in a pension plan and the value of your retirement account). Liabilities include:

- The entire amount of recourse debts, and
- The amount of nonrecourse debt that is not in excess of the FMV of the property that is security for the debt.

Note. This exclusion does not apply to a cancellation that occurs in a title 11 bankruptcy case. This exclusion also does not apply if the debt is qualified principal residence indebtedness (defined in this section under *Qualified Principal Residence Indebtedness*, later) unless you elect to apply the insolvency exclusion instead of the qualified principal residence indebtedness exclusion.

How to report the insolvency exclusion. To show that you were insolvent and that you are excluding canceled debt from income to the extent you were insolvent immediately before the cancellation, attach Form 982 to your federal income tax return and check the box on line 1b. On line 2, include the smaller of the amount of the debt canceled or the amount by which you were insolvent immediately before the cancellation. You must also reduce your tax attributes in Part II of Form 982 as explained under *Reduction of Tax Attributes*, later.

Example 1. In 2007, Greg was released from his obligation to pay his personal credit card debt in the amount of $5,000. Greg received a 2007 Form 1099-C from his credit card lender showing canceled debt of $5,000 in box 2. The FMV of Greg's total assets immediately before the cancellation was $7,000 and his total liabilities were $15,000. This means that immediately before the cancellation, Greg was insolvent to the extent of $8,000 ($15,000 total liabilities minus $7,000 FMV of his total assets). Because the amount by which Greg was insolvent immediately before the cancellation exceeds the amount of his debt canceled, Greg can exclude the entire $5,000 canceled debt from income.

When completing his tax return, Greg checks the box on line 1b of Form 982 and enters $5,000 on line 2. Greg completes Part II to reduce his tax attributes as explained under *Reduction of Tax Attributes*, later. Greg does not include any of the $5,000 canceled debt on line 21 of his Form 1040. None of the canceled debt is included in his income.

Example 2. Assume the same facts as in Example 1 except that the FMV of Greg's total assets immediately before the cancellation was $7,000 and his total liabilities were $10,000. In this case, Greg is insolvent to the extent of $3,000 ($10,000 total liabilities minus $7,000 FMV of his total assets) immediately before the cancellation. Because the amount of the canceled debt exceeds the amount by which Greg was insolvent immediately before the cancellation, Greg can exclude only $3,000 of the $5,000 canceled debt from income under the insolvency exclusion.

Greg checks the box on line 1b of Form 982 and includes $3,000 on line 2. Also, Greg completes Part II to reduce his tax attributes as explained under *Reduction of Tax Attributes,* later. Additionally, Greg must include $2,000 of canceled debt on line 21 of his Form 1040 (unless another exception or exclusion applies).

Qualified Farm Indebtedness

You can exclude canceled farm debt from income if all of the following apply.

- The debt was incurred directly in connection with the operation of the trade or business of farming.
- 50% or more of your total gross receipts for 2004, 2005, and 2006 were from the trade or business of farming.
- The cancellation was made by a qualified person. A qualified person is an individual, organization, etc., who is actively and regularly engaged in the business of lending money. A qualified person includes any federal, state, or local government, agency or instrumentality thereof. The United States Department of Agriculture is a qualified person. This person cannot be related to you, be the person from whom you acquired the property (or a person related to this person), or be a person who receives a fee due to your investment in the property (or a person related to this person).

For the definition of the term "related person," see *Related persons* under *At-Risk Amounts* in Publication 925.

Note. This exclusion does not apply to a cancellation of debt in a title 11 bankruptcy case or to the extent you were insolvent immediately before the cancellation. If qualified farm debt is canceled in a title 11 case, you must apply the bankruptcy exclusion rather than the exclusion for canceled qualified farm debt. If you were insolvent immediately before the cancellation of qualified farm debt, you must apply the insolvency exclusion before applying the exclusion for canceled qualified farm debt.

Exclusion limit. The amount of canceled qualified farm debt that you can exclude from income is limited. It cannot exceed the sum of your adjusted tax attributes and the total adjusted bases of qualified property you held at the beginning of 2008. For purposes of determining the limit on the exclusion for canceled qualified farm debt, the adjusted basis of any qualified property and adjusted tax attributes are determined after any reduction of tax attributes required because of the application of the insolvency exclusion for canceled debt.

Adjusted tax attributes. Adjusted tax attributes means the sum of the following items.

1. Any net operating loss (NOL) for 2007 and any NOL carryover to 2007.
2. Any net capital loss for 2007 and any capital loss carryover to 2007 under Internal Revenue Code section 1212.
3. Any passive activity loss carryover from 2007.
4. Three times the sum of any:
   a. General business credit carryover to or from 2007,
   b. Minimum tax credit available as of the beginning of 2008,
   c. Foreign tax credit carryover to or from 2007, and
   d. Passive activity credit carryover from 2007.

Qualified property. This is any property you use or hold for use in your trade or business or for the production of income.

How to report the qualified farm indebtedness exclusion. To show that all or part of your canceled debt is excluded from income because it is qualified farm debt, attach Form 982 to your federal income tax return and check the box on line 1c. On line 2 of Form 982, include the amount of qualified farm debt canceled, but not more than the amount of the exclusion limit (explained earlier). You must also reduce your tax attributes in Part II of Form 982 as explained under *Reduction of Tax Attributes,* later.

Example 1. In 2007, Chuck was released from his obligation to pay a $10,000 debt that was incurred directly in connection with his trade or business of farming. Chuck received a Form 1099-C from the qualified lender showing canceled debt of $10,000 in box 2. For the 2004, 2005, and 2006 tax years, at least 50% of Chuck's total gross receipts were from the trade or business of farming. Chuck's adjusted tax attributes are $5,000 and Chuck has $3,000 total adjusted bases in qualified property at the beginning of 2008. Chuck had no other debt canceled during 2007 and he does not fall into any other exception or exclusion relating to canceled debt income.

Chuck can exclude $8,000 ($5,000 of adjusted tax attributes plus $3,000 total adjusted bases in qualified property at the beginning of 2008) of the $10,000 canceled debt from income. Chuck checks the box on line 1c of Form 982 and enters $8,000 on line 2. Also, Chuck completes Part II to reduce his tax attributes as explained under *Reduction of Tax Attributes,* later. The remaining $2,000 of canceled qualified farm debt is included in Chuck's income on Schedule F, line 10.

Example 2. On March 1, 2007, Bob was released from his obligation to pay a $10,000 business credit card debt that was used directly in connection with his farming business. For the 2004, 2005, and 2006 tax years at least 50% of Bob's total gross receipts were from the trade or business of farming. Bob received a 2007 Form 1099-C from the qualified lender showing canceled debt of $10,000 in box 2. The FMV of Bob's total assets on March 1, 2007 (immediately before the cancellation of the credit card debt) was $7,000 and Bob's total liabilities at that time were $11,000. Bob's adjusted tax attributes (a 2007 NOL) are $7,000 and Bob has $4,000 total adjusted bases in qualified property at the beginning of 2008.

Bob qualifies to exclude $4,000 of the canceled debt under the insolvency exclusion because he is insolvent to the extent of $4,000 immediately before the cancellation ($11,000 total liabilities minus $7,000 FMV of total assets). Bob also qualifies to exclude the remaining $6,000 of canceled qualified farm debt. The limit on Bob's exclusion from income of canceled qualified farm debt is $7,000, the sum of his adjusted tax attributes of $3,000 (determined after taking into account the reduction of tax attributes required because of the exclusion of $4,000 of the canceled debt from Bob's income under the insolvency exclusion) plus $4,000 (Bob's total adjusted bases in qualified property at the beginning of 2008).

Bob checks the boxes on lines 1b and 1c of Form 982 and enters $10,000 on line 2. Bob completes Part II to reduce his tax attributes as explained under *Reduction of Tax Attributes,* later. Bob must reduce his tax attributes under the insolvency rules before applying the rules for qualified farm debt. Bob does not include any of his canceled debt in income.

Example 3. Assume the same facts as in Example 2 except that immediately before the cancellation Bob was insolvent to the extent of the full $10,000 canceled debt. Because the exclusion for qualified farm debt does not apply to the extent that you were insolvent immediately before the cancellation, Bob checks only the box on line 1b of Form 982 and enters $10,000 on line 2. Bob completes Part II to reduce his tax attributes based on the insolvency exclusion as explained under *Reduction of Tax Attributes,* later. Bob does not include any of the canceled debt in income.

Qualified Real Property Business Indebtedness

You can elect to exclude canceled qualified real property business indebtedness from income. Qualified real property business indebtedness is debt (other than qualified farm debt) that meets all of the following conditions.

1. It was incurred or assumed in connection with real property used in a trade or business.
2. It is secured by such real property.
3. It was incurred or assumed at either of the following times.
   a. Before 1993.
   b. After 1992, if the debt is either (i) qualified acquisition indebtedness (defined below), or (ii) debt incurred to refinance qualified real property business debt incurred or assumed before 1993 (but only to the extent the amount of such debt does not exceed the amount of debt being refinanced).
4. It is debt to which you elect to apply these rules.

Qualified acquisition indebtedness. Qualified acquisition indebtedness is: