

Debt Cancellation: “What is my income tax liability post-foreclosure?”

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When a mortgage lender forgives a borrower’s debt through a foreclosure, it elects to discharge the remaining principal of the debt, usually because the lender considers the debt to be uncollectible. After a lender elects to forgive the debt, the borrower as a taxpayer must then determine whether the forgiven debt will become taxable income. To address this issue in the current housing crisis, Congress enacted the Mortgage Forgiveness Debt Relief Act of 2007¹ (“MFDRA”) on December 20, 2007 for the purpose of excluding income which may be taxable as a result of debt forgiveness related to foreclosures, short sales, consent foreclosures, and loan modifications.

The concept of debt forgiveness is that the ordinary taxable income of a taxpayer includes the portion of debts which are forgiven by the lender. Section 2 of the MFDRA changes the Internal Revenue Code (“IRC”) to allow a taxpayer to exclude income from the discharge of indebtedness under Section 108 of the IRC.² Pursuant to the new provision, gross income is no longer included as income if it is “qualified principal residence indebtedness which is discharged before January 1, 2010.”³

To prevent any abuse of this provision and to ensure that it is used only for its intended purpose, Congress enacted certain qualifying guidelines. First, the provision only applies to qualified principal residence indebtedness.⁴ For purposes of debt forgiveness, principal residence shares the same definition that is used in IRC Section 121. Section 121 excludes the first

¹ Pub.L. No. 110-142, 121 Stat. 1803.

² Mortgage Forgiveness Debt Relief Act of 2007 §2(a).

³ *Id.*

⁴ *Id.*

\$250,000 (\$500,000 in the case of a joint return) in gain from the sale of a taxpayer's principal residence) from taxable income.⁵ Therefore, the new Section 108 exclusion would not be applicable to second homes, vacation homes, or investment properties.

Second, the changes to Section 108 cap the amount of qualified principal residence indebtedness at \$2,000,000.00 and \$1,000,000.00 in the case of a married taxpayer filing a separate return.⁶ Basically, what that means is that if a lender forgives the debt on the taxpayer's home mortgage, up to \$2,000,000.00 of the amount forgiven will not qualify as taxable income to the taxpayer. However, any amount forgiven that exceeds the \$2,000,000.00 cap will count as taxable income on that year's tax return.

The MFDRA also includes home equity debt as part of debt forgiveness. However, only home equity debt that was used to improve the residence where the residence collateralized the loan qualifies for forgiveness under the act.⁷ Home equity debt that was used for other expenses, such as personal bills, vacations, or college tuition does not qualify to be forgiven.

Third, this exclusion from income only applies to discharges that arise directly from the declining value of the residence or the distressed financial position of the taxpayer.⁸ The following situations are deemed to be qualifying circumstances: 1) modification of the terms of a

⁵ Section 2(b) amended subsection (h)(1) of I.R.C. §108. I.R.C. §121(a) to define property as “principal residence” if “during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating [two] years or more.” Mortgage Forgiveness Debt Relief Act of 2007 §2(b).

⁶ Section 2(b) amended subsection (h)(2) of I.R.C. §108 to define “qualified principal residence indebtedness” as “acquisition indebtedness” under I.R.C. §163(h)(3)(B), which “(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and (II) is secured by such residence” and also includes “indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of [I.R.C. §163(h)(3)(B)(i)]...but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.” Mortgage Forgiveness Debt Relief Act of 2007 §2(b).

⁷ I.R.C. §163(h)(3)(B)(i)(I) (2008).

⁸ Section 2(b) amended subsection (h)(3) of I.R.C. §108: exception for certain discharges not related to taxpayer's financial condition.--Subsection (a)(1)(E) [of I.R.C. §108] shall not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer. Mortgage Forgiveness Debt Relief Act of 2007 §2(b).

mortgage, 2) a short payoff, or 3) foreclosure of the taxpayer's principal residence. Although, as mentioned above, only the portion of the discharged loan that is qualified principal residence indebtedness will be excluded from taxable income.⁹

For example, suppose a taxpayer lives in a principal residence with a mortgage of \$300,000 and the tax payer takes out a home equity loan for \$150,000. The taxpayer uses \$100,000 of the home equity loan to add a sunroom to the house and uses \$50,000 to start a business. Assuming that the taxpayer's financial condition caused him to go into foreclosure and lose his home, the taxpayer would be able to exclude \$400,000 of the discharge of indebtedness from his income. He would still have to pay taxes on the \$50,000 that he used to start a business.

Lenders who forgive debt in excess of \$600.00 are required to issue a Form 1099-C. This form will reflect the amount of the forgiven debt. Further, the amount of forgiven debt to be excluded from the taxable income of the borrower must be reported on IRS Form 982 and attached to the tax return of the borrower.¹⁰

⁹ Mortgage Forgiveness Debt Relief Act of 2007 §2(b) amended subsection (h)(4) of I.R.C. §108.

¹⁰ <http://www.irs.gov/newsroom/article/0,,id=174034,00.html>