

The Mortgage Forgiveness Debt Relief Act and Debt Cancellation

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If you owe a debt to someone else and they cancel or forgive that debt, the canceled amount may be taxable.

The Mortgage Debt Relief Act of 2007 generally allows taxpayers to exclude income from the discharge of debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief.

This provision applies to debt forgiven in calendar years 2007 through 2012. Up to \$2 million of forgiven debt is eligible for this exclusion (\$1 million if married filing separately). The exclusion does not apply if the discharge is due to services performed for the lender or any other reason not directly related to a decline in the home's value or the taxpayer's financial condition.

The following are some of the most commonly asked questions and answers about The Mortgage Forgiveness Debt Relief Act and debt cancellation:

What is Cancellation of Debt?

If you borrow money from a commercial lender and the lender later cancels or forgives the debt, you may have to include the cancelled amount in income for tax purposes, depending on the circumstances. When you borrowed the money you were not required to include the loan proceeds in income because you had an obligation to repay the lender. When that obligation is subsequently forgiven, the amount you received as loan proceeds is normally reportable as income because you no longer have an obligation to repay the lender. The lender is usually required to report the amount of the canceled

debt to you and the IRS on a Form 1099-C, Cancellation of Debt.

Is Cancellation of Debt Income Always Taxable?

Not always. There are some exceptions. The most common situations when cancellation of debt income is not taxable involve:

* **Qualified principal residence indebtedness:** This is the exception created by the Mortgage Debt Relief Act of 2007 and applies to most homeowners.

* **Bankruptcy:** Debts discharged through bankruptcy are not considered taxable income.

* **Insolvency:** If you are insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable to you. You are insolvent when your total debts are more than the fair market value of your total assets.

* **Certain farm debts:** If you incurred the debt directly in operation of a farm, more than half your income from the prior three years was from farming, and the loan was owed to a person or agency regularly engaged in lending, your cancelled debt is generally not considered taxable income.

* **Non-recourse loans:** A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue you personally in case of default. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in cancellation of debt income. However, it may result in other tax consequences.

The Mortgage Forgiveness Debt Relief Act of 2007

The Mortgage Forgiveness Debt Relief Act of 2007 was enacted on December 20, 2007. Generally, the Act allows exclusion of income realized as a result of modification of the terms of the mortgage, or foreclosure on your principal residence.

What Does Exclusion of Income Mean?

Normally, debt that is forgiven or cancelled by a lender must be included as income on your tax return and is taxable. But the Mortgage Forgiveness Debt Relief Act allows you to exclude certain cancelled debt on your principal residence from income. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief.

Applicability of the Act

The Act applies only to forgiven or cancelled debt used to buy, build or substantially improve your principal residence, or to refinance debt incurred for those purposes. In addition, the debt must be secured by the home. This is known as qualified principal residence indebtedness. The maximum amount you can treat as qualified principal residence indebtedness is \$2 million or \$1 million if married filing separately.

Debt used to refinance your home qualifies for this exclusion, but only to the extent that the principal balance of the old mortgage, immediately before the refinancing, would have qualified.

"Sunset" Provision

The Act applies to qualified principal residence indebtedness forgiven in calendar years 2007 through 2012.

Second Homes, Credit Cards, Car Loans

Only cancelled debt used to buy, build or improve your principal residence or refinance debt incurred for those purposes qualifies for this exclusion.

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* Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Fourth and Ninth Circuits, federal trial courts in the Northern District of California, and the United States Tax Court. He has also served as a Judge Pro Tempore for the Santa Clara Superior Court. In addition to practicing law, Mr. Earle is also a licensed Real Estate Broker.

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