

Mortgage Debt Forgiveness – Key Facts

In late December 2007, Congress passed legislation changing the tax code as relates to mortgage debt forgiveness. Ordinarily, debt forgiveness – including short sales, short refinances, deed-in-lieu of foreclosure or other ways lenders forgive debt owed - counts as taxable income, unless it falls into one of the tax code’s exemptions.

Previously, homeowners who had obtained debt forgiveness from their mortgage lender had to claim the “Insolvency Exception” to paying tax on the additional “income” that the debt forgiveness produced. However, the IRS’s insolvency test is very stringent (it takes retirement funds into account, for example). In addition, many homeowners did not know about the insolvency exception, even if they did qualify. In order to address this, Congress passed a change to the tax code, offering an exception specifically targeted for home mortgage debt forgiveness.

Minnesota homeowners need to know that there are a number of stipulations in the legislation:

1. The burden is on the taxpayer to assert the exception.

In other words, debt forgiveness (short sale, deed-in-lieu, permanent loan modification, etc) still counts as income and lenders are required to issue Form 1099-C to the homeowner whose debt was forgiven. It is then the taxpayer’s burden to tell the IRS that they qualify for an exception to paying tax on this income. To do so, they need to fill out a special form (Form 982), which can only be used with the long-form 1040 as opposed to the 1040A or 1040EZ.

CAUTION

**Exceptions are not automatic.
Taxpayers must file Form 982
with the long-form 1040 when
filing their taxes.**

2. The exception is only for “qualified” debt, which is defined to exclude any cash-out in a refinancing.

The exception for debt forgiveness only qualifies if the original debt was incurred for home acquisition or to pay for home improvement costs – not cash out to pay other bills. Any cash-out amount is subtracted off the top of any debt forgiveness amount before the exception kicks in. For example, if a homeowner refinanced their home with a \$120,000 loan, of which \$15,000 was cashed out to pay debts unrelated to home improvement, and then sells short for \$100,000 - with the lender agreeing to forgive the remaining \$20,000 - only \$5,000 of this amount will qualify for the exception. *The taxpayer will need to pay income tax on the remaining \$15,000 of forgiven debt.*

3. Lower-income taxpayers claiming this exception cannot use VITA clinics or the IRS tax clinics.

VITA or IRS tax clinics cannot assist taxpayers who need to fill out the long-form 1040. Plus, Form 982 is likely to be too complicated for many people to fill out themselves. Most people in this situation will need to pay a private tax preparer.

This information is provided as a service of the Minnesota Home Ownership Center and is not legal or tax advice. Consult a professional regarding your specific tax and legal obligations.

For information on how to contact your Mortgage Support Advisors, call the Minnesota Home Ownership Center today: (651) 659-9336 or (866) 462 – 6466 or visit hocmn.org.