

TAX CONSEQUENCES OF FORGIVEN DEBT

by Terri A. Lastovka

Foreclosure filings in Cuyahoga County were up by 13% for the first six months of 2010 over the same period in 2009. Some communities saw increases as high as 18%. The Director of the county's foreclosure prevention program described it as "discouraging, but not unexpected and it's extremely significant", and then added "I don't see it getting better for at least two, maybe three years." Filings in Ohio are projected to exceed 90,000 for the year 2010.

It is devastating for a family to lose their home. First the job loss, then the foreclosure. The bank only sees negative numbers and stacks of paperwork. The family, however, is now on the street looking for a place to lay their weary heads at night ... survival. Yes, shelter is one of our primal survival needs. Add insult to injury

by adding the IRS to the mix.

Mortgage debt is considered recourse debt, where the debtor is responsible for the balance after the collateral is exhausted. What happens when the bank ultimately sells the house, applies the proceeds to the outstanding mortgage, pays the fees incident to the foreclosure and sale, and there is still a balance due on that mortgage? There is nothing left of the collateral. So the bank has no choice but to write it off (i.e. forgive the debt). Enter the Tax Man.

Because the homeowner received money to buy the house but did not repay all the money borrowed, he/she now has income. And we all know that the IRS wants to see taxes paid on income. The bank ultimately issues a Form 1099 indicating the amount of debt that was forgiven or cancelled; whether it be through a foreclosure, deed in lieu of foreclosures, short sale, or debt restructure. The debt that is forgiven is considered ordinary income. However, some of that income may potentially be categorized as capital gain if the home was purchased for less than what the bank ultimately sold it for after the foreclosure. This could ease the tax burden to some extent.

But wait, the Tax Man is kept at bay. Congress enacted the Mortgage Forgiveness Debt Relief Act in December 2007. Although initially scheduled to expire in 2009, Congress recognized the continued need and extended it through 2012. This piece of legislation is specific to "qualified principal residence indebtedness", limited to \$2 million (\$1 million if married filing jointly). The individual receiving this Form 1099 for the cancelled or forgiven debt can exclude this amount from income if the debt meets certain criteria:

a) The mortgage taken was to buy, build,

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or substantially improve your principal residence (not vacation home);

- b) The mortgage is secured by your principal residence;
- c) Home equity lines of credit also qualify if they meet the above criteria;
- d) Refinanced mortgages also qualify, but only to the extent of balance of the old mortgage just before refinancing (insuring that criteria "a" above is met - to buy, build or substantially improve the home).

Is it possible that only part of the forgiven debt qualifies for relief under the Act? Absolutely. Jane, for example, bought a \$315,000 home in 2003 taking out a \$300,000 mortgage. The mortgage was secured by the home. The following year, she took a second mortgage (home equity) loan in the amount of \$50,000 to add a garage to her home.

A few years later when the two loans combined was \$325,000, Jane refinanced the two loans

into one in the amount of \$400,000. Jane used the extra funds of \$75,000 to buy a car, pay off some credit cards, and to pay college tuition for her daughter.

After the refinancing, the qualified principal residence indebtedness remains at \$325,000; which is the combined balances of qualified principal residence indebtedness immediately before the refinancing. The remaining amount that was cashed out during the refinance was used for things unrelated to the acquisition or substantial improvement of the home, and therefore does not qualify for relief under the Act.

When the Form 1099 arrives from the lender, Jane must complete Form 982 and attach to her federal income tax return. Only 3 of the 13 lines on the form apply to residential mortgage debt forgiveness. Check the box on line 1(e) and include the amount of cancelled debt on line 2. If Jane continues to live in the home after the cancellation of debt (by way of debt restructure), she must reduce her basis in the home by the amount of the forgiven debt and report that on line 10(b) of Form 982.

Remember, this congressional relief is specific to Qualified Principal Residence Indebtedness. Debt for vacation homes, rental properties, or business purposes need not apply.

If Jane is looking for relief from that \$75,000 that she cashed out on her refinance to buy the car, pay down her credit cards, and pay her daughter's tuition, she can look to other provisions of the Tax Code.

In 1980, Congress codified the insolvency exception by enacting provisions that exclude from income the cancelled debt of taxpayers who are insolvent, or under the supervision of a court in bankruptcy proceedings. The term "insolvent" means the excess of liabilities over the fair market value of assets. The bankruptcy provision applies to all proceedings under Title 11, including Chapter 7 liquidations and Chapter 11 reorganizations.

In 1986, Congress enacted a provision that excludes from income the discharged debt related to qualified farm indebtedness. For this exclusion, the debt must have been incurred directly in connection with the operation of the taxpayer's farming business, and at least 50% of the taxpayer's gross receipts for the most recent three years is attributable to the business of farming. Leasing land to another farmer is not attributable to operating a farm and therefore will not qualify as farming operations receipts.

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In 1993, Congress enacted a provision that permits the exclusion from income the discharge of "qualified real property business indebtedness. This debt must be in connection with real property that is used in a trade or business, and is secured by such property. The nexus of the debt is to the qualified real property, not necessarily to the trade or business. The connection between the debt and the real property must exist at the time when the debt is incurred.

An exclusion from income is also available for certain student loans. This exclusion applies if the discharge was pursuant to a provision of the loan under which all or part of the debt of an individual would be discharged if the individual "worked for a certain period of time in certain professions for any of a broad class of employers." Examples that fall in to this category are the Loan Repayment Assistance Programs for law school loans and the National Health Service Corps Loan Repayment Program.

If you have multiple types of loans and a variety of exceptions working for you, they must be taken in the proper order. The bankruptcy exclusion takes precedence over the insolvency exclusion. Thus, if a debt cancellation occurs

in a bankruptcy proceeding, the insolvency exclusion does not apply.

In the event that the taxpayer qualifies under the insolvency exclusion and the principal residence exclusion, the principal residence exclusion takes precedence over the insolvency exclusion unless the taxpayer elects to apply the insolvency exception.

It is difficult enough to suddenly become a renter after losing the American Dream of being a homeowner. But to then have to pay taxes on that devastating loss! This is a time where our government has acknowledged this devastation and has provided a means to minimize the loss. We can only hope that this need will not continue for too long. ➤



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