

Will I Pay Tax on Short Sales, Foreclosures or Loan Modifications?

(As of August 20, 2014)

As with many tax laws, the answer to this question is “It depends.” Legislation enacted in December 2007 provides relief for many homeowners who face short sales, foreclosures and even those who successfully rework existing debt in order to stay in their houses. As with any tax provision, check with an advisor.

Vocabulary: This area of the tax law has its own lingo. Here are important terms:

Discharge of debt or cancellation of indebtedness income: A general rule of tax law is that if a lender forgives all or some portion of a borrower’s debts, the amount that’s forgiven is considered income to the borrower. The theory is that the borrower has consumed the funds, so being freed of any need to repay them is economically the equivalent of income. Exceptions do apply, however.

Acquisition indebtedness: Homeowners are entitled to deduct their mortgage interest payments from their gross income, but some limits, including acquisition indebtedness, apply. Acquisition indebtedness is the amount borrowed to acquire, construct, reconstruct, improve or rehabilitate a residence. Acquisition debt can be refinanced. If mortgage debt is incurred to make improvements to the home, that amount is considered acquisition indebtedness. If a mortgage is simply a cash-out refinancing, the cash-out amount is *not* acquisition indebtedness. Acquisition indebtedness must be secured by the principal residence to utilize the relief provision.

Short sale: If, at the time a home is sold, a borrower cannot repay the amount outstanding on the mortgage, the lender forgives the shortfall and allow the borrower’s sale to be completed.

Workout: The borrower and lender agree to restructure a mortgage by reducing the amount of the debt. The borrower stays in the home and pays the new mortgage.

1099: When a lender forgives debt, the lender is required to provide an IRS Form 1099 information return to the borrower and to the IRS showing the amount of debt that has been forgiven.

Good News for Borrowers

The Mortgage Forgiveness Debt Relief Act of 2007 provides that when lenders forgive some portion of a mortgage debt or agree to a workout or loan modification, the forgiven amount will NOT be treated as taxable income. Unfortunately, this provision expired at the end of 2013, but may be reinstated retroactively. Here are the features of that relief:

FEATURE	PROVISION
Is all forgiven mortgage debt non-taxable?	No. Only debt on a <i>principal residence</i> is eligible for the exclusion.

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Is there a dollar limit on the amount of mortgage debt that is eligible for the relief?	Yes. No more than \$2 million may be excluded from taxation. (\$1 million on a married filing separately tax return.) Any amount above those limits will be taxed at ordinary income rates.
Is there an income limit on the borrower?	No. Any borrower, no matter how high or how low his/her income, qualifies for this relief.
If I refinanced, am I eligible for relief?	Refinanced amounts <i>less than or equal to</i> the acquisition indebtedness, are eligible for the relief.
Is cash-out refinancing qualified for relief?	Generally, no . Cash used for construction, improvements or rehabilitation of the home can sometimes qualify, depending on circumstances. Documentation is essential.
What about any home equity loan/line of credit on the house?	Funds from this type of financing are eligible for the relief ONLY if the funds were applied to structural improvements to the home. Documentation is essential.
What about the mortgage on my rental property?	Rental property, even if it is residential property, is subject to a different set of rules. Some borrowers who own rental properties that are foreclosed or in short sales or workouts may qualify for mortgage cancellation relief under rules enacted in 1993 that apply to investment property. That relief has several limitations.
Will I get a 1099 for the forgiven amount?	Yes. The lender is still required to provide a 1099 to you and to the IRS. The amount reported on the 1099 will not be taxed unless the forgiven amount is ineligible for the exclusion, such as debt on a second home (non-rental), forgiven debt in excess of \$2 million, cash-out refinancing or if other exceptions apply.
How long is this relief in effect?	The relief applies to mortgage debt forgiven between January 1, 2007 and December 31, 2013.
Is there a chance the tax relief will be extended beyond 2013?	Yes. Bills have been introduced to extend the relief. Congress may act in the fall of 2014 to retroactively reinstate the exclusion.