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10 things to know about mortgage debt forgiveness

Real Estate Tax Talk

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Over the past several years, millions of homeowners have had billions of dollars in mortgage debt forgiven, either through foreclosure, refinancing or short sales. It's important for real estate professionals and homeowners to understand that mortgage debt forgiveness has significant tax consequences.

Here are 10 things the Internal Revenue Service says you should know about mortgage debt forgiveness:

1. Normally, when a lender forgives a debt -- that is, relieves the borrower from having to pay it back -- the amount of the debt is taxable income to the borrower. Thus, a homeowner who had \$100,000 in mortgage debt forgiven through a short sale would have to pay income tax on that \$100,000, as an example.

Fortunately, under the Mortgage Forgiveness Debt Relief Act of 2007, you may be able to exclude from your taxable income up to \$2 million of debt forgiven on your principal residence from 2007 through 2012. This means you don't have to pay income tax on the forgiven debt.

2. The limit is \$1 million for a married person filing a separate return.
3. You may exclude from your taxable income debt reduced through mortgage restructuring, as well as mortgage debt forgiven in a foreclosure.
4. To qualify, the debt must have been used to buy, build or substantially improve your principal residence and be secured by that residence.
5. The **Mortgage Forgiveness Debt Relief Act** applies to home improvement mortgages you take out to substantially improve your principal residence -- that is, they also qualify for the exclusion.
6. Second or third mortgages you used for purposes other than home improvement -- for example, to pay off credit card debt -- do not qualify for the exclusion.
7. If you qualify, claim the special exclusion by filling out **Form 982: Reduction of Tax Attributes Due to Discharge of Indebtedness**, and attach it to your federal income tax return for the tax year in which the debt was forgiven.
8. Debt forgiven on second homes, rental property, business property, credit cards or car loans does not qualify for the tax-relief provision. In some cases, however, other tax-relief provisions -- such as bankruptcy -- may be applicable. IRS Form 982 provides more details about these provisions.
9. If your debt is reduced or eliminated, you normally will receive a year-end statement, Form 1099-C: Cancellation of Debt, from your lender. By law, this form must show the amount of debt forgiven and the fair market value of any property foreclosed.

10. Examine the Form 1099-C carefully. Notify the lender immediately if any of the information shown is incorrect. You should pay particular attention to the amount of debt forgiven in Box 2 as well as the value listed for your home in Box 7.

The IRS has created a highly useful [Interactive Tax Assistant](#) on its website that you can use to determine if your canceled debt is taxable. The tax assistant tool takes you through a series of questions and provides you with responses to tax law questions.

For more information about the Mortgage Forgiveness Debt Relief Act of 2007, see IRS Publication 4681: Canceled Debts, Foreclosures, Repossessions and Abandonments. You can get it from the IRS website at irs.gov.

Stephen Fishman is a tax expert, attorney and author who has published 18 books, including "Working for Yourself: Law & Taxes for Contractors, Freelancers and Consultants," "Deduct It," "Working as an Independent Contractor," and "Working with Independent Contractors." He welcomes your questions for this weekly column.

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