# The Mortgage Forgiveness Debt Relief Act of 2007 Expires December 31, 2012

**By Andrew M. Lieb**

If you litigate foreclosures pay attention. Transactional attorneys take notice. Whether you are a generalist or focus your practice in debt relief it is your job to know that an act with great implication to our region is expiring. While many have commented that they have it on good authority that the Act will be extended and logic dictates that it should, your author is a realist and believes that until something happens, nothing has happened. So let's discuss what is without a doubt one of the Bush era's most logical legislative accomplishments and the implications of its expiration.

Cancellation of debt income is reported on IRS Form 1099-C by the creditor for each debtor for whom the creditor canceled $600 or more of a debt owed. The relevant IRS publication on this topic is Publication 4681, entitled "Canceled Debts, Foreclosures, Repossessions, and Abandonments." Therein, Canceled Debts are explained as follows: "if a debt for which you are personally liable is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your income." Therefore, pursuant to Publication 4681, a mortgage modification that includes a principal reduction will result in income tax to the debtor. Likewise, a short sale that includes principal forgiveness will result in income tax to the debtor. Additionally, a deed-in-lieu of foreclosure will also result in income tax to the debtor where any underwater sums are released on the recourse note.

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However, The Mortgage Forgiveness Debt Relief Act of 2007 avoided this income tax outcome for many homeowners in our county and throughout the United States. According to the IRS, the Act "allows taxpayers to exclude income from the discharge of debt on their principal residence." To obtain this relief, the taxpayer was required to file Form 982 and attach it to their federal income tax return. Pursuant to Form 982, a principal residence is defined as follows: "your main home, which is the home where you ordinarily live most of the time. You can have only one main home at any one time."

Moreover, the form caps the exclusion from taxable income as follows:

> "This indebtedness is a mortgage you took out to buy, build, or substantially improve your main home. It also must be secured by your main home. If the amount of your original mortgage is more than the cost of your main home plus the cost of any substantial improvements, only the debt that is not more than the cost of your main home plus improvements is qualified principal residence indebtedness. Any debt secured by your main home that you use to refinance qualified principal residence indebtedness is treated as qualified principal residence indebtedness, but only up to the amount of the old mortgage principal just before the refinancing. Any additional debt you incurred to substantially improve your main home is also treated as qualified principal residence indebtedness." Lastly, the "maximum amount you can treat as qualified principal residence indebtedness is $2 million."

During the previous five years it has become commonly understood among all real estate industry professionals that short sales on a primary residence will not result in income tax. Real estate brokers and salespersons preach this gospel when making their short sale listing presentations. Attorneys support this understanding when engaging in negotiations and/or closing a short sale transaction. In fact, accountants ratify this understanding when preparing tax returns. Our message must be changed.

As attorneys we are charged with the duty to advise clients and the public with an understanding of the laws that will impact their lives. Hopefully, The Mortgage Forgiveness Debt Relief Act of 2007 will be extended. Yet, it's imperative for practitioners to begin advising clients and ancillary real estate service providers with whom we work that this act is set to expire and that they must make informed strategic decisions under this light. While the Act existed, a short sale offered credit score and esteem advantages over bankruptcy coupled with the fact that the debtor in a short sale would not be precluded from filing for bankruptcy for eight years. Yet, with the Act expiring, it is submitted that a discharge of a Mortgage Note pursuant to a Chapter 7 Bankruptcy is the best practice as opposed to obtaining debt forgiveness in a short sale. Our advice to clients should mirror this understanding as obtaining debt forgiveness in a short sale will cost the homeowner thousands of dollars in taxes should the Act not be extended.

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