

Hidden IRS Tax Consequences of Home Mortgage Debt Forgiveness

By Lawrence 'D' Pew, [Arizona Tax Attorney](#)

Your debt consolidation company assures you that several of your creditors have agreed to forgive what you owe them – they've decided to write off the debts for good. Sounds terrific right?

BEWARE! *There are hidden tax consequences when debts are forgiven by your creditors.*

How Does the IRS View Debt Cancellation?

Did your debt consolidation company or credit counseling company explain to you that the IRS views almost all debt cancellations as an increase to your income? You may not have any more money, but because you didn't have to pay money to a creditor – in the collective mind of the IRS – your gross income increased.

You Can't Hide from Form 1099-C

When a creditor cancels your debt of \$600 or more, you'll receive a [Form 1099-C "Cancellation of Debt"](#) from that creditor or lender. That is your first clue that the IRS has been notified of the debt forgiveness. The amount reported on 1099-C will be added to your reportable income and you will be assessed income tax on that forgiven obligation. Are you wondering if a cancelled mortgage obligation will also be added to your gross income? *Well, that depends upon the year of cancellation.*

When the Cancelled Debt Is Your Home Loan

Was your home foreclosed on, but you did not file for bankruptcy relief? Did your lender later determine the debt was uncollectible and, prior to 2007, forgave the balance still owing? Then the amount your lender graciously cancelled instantly shifted over to your gross income for tax purposes.

Assume, for example, that your home in Arizona City was foreclosed on in 2005, was sold at auction, and the proceeds were applied to reduce your debt. Even after the sale, however, you and your spouse still owed your lender \$50,000 on the original purchase note. After negotiating intensely, in 2006 your lender agreed to forgive \$40,000 of the amount still owing. You received a Form 1099-C with the cancelled \$40,000 debt added to your gross income, and upon which you were assessed income tax. That was the likely result in 2006. *But in 2007 things changed for home-loan borrowers, at least temporarily.*

Exception to Income Tax on Forgiven Mortgage Obligations Between 2007 and 2012

The [Mortgage Forgiveness Debt Relief Act of 2007 \(MFDRA\)](#) was passed by Congress to exclude debts forgiven on a taxpayer's principal residence, so long as the cancelled debt amount does not exceed \$2 million. (If your filing status was married filing separately, then the limit on the MFDRA exception is \$1 million.)

This valuable tax relief is available for mortgage debts forgiven between 2007 and 2012. If you believe your cancelled debt falls within the MFDRA exception, then make sure the lender completed Form 1099-C to accurately reflect the amount forgiven and the value of the home. And to claim the MFDRA mortgage exception, make sure to complete [IRS Form 982](#). If you did not claim this exception for tax year 2007 through 2010, then you should consult with an Arizona tax attorney to determine the best course of action in amending past returns. And if your home loan was forgiven in 2011, make sure include IRS Form 982

with your 2011 income tax return. (There is a tax exception for certain cancelled student loans and otherwise deductible debts, which we'll reserve for future discussion.)

Debts Cancelled in Bankruptcy Are Excluded from Taxable Income

So there is no confusion, debts discharged in bankruptcy are excluded from your taxable income. Generally, the tax issues associated with debt forgiveness occur outside of bankruptcy and are frequently the result of debt consolidations through third parties. *The MFDRA is the exception, not the rule.* Please visit our website to read more about the [Dangers of Credit Counseling and Debt Consolidation Companies](#).

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Lawrence 'D' Pew is an experienced tax, bankruptcy, and transactional attorney, and founder of the Pew Law Center, PLLC, a leading Arizona tax and bankruptcy law firm focused exclusively on debt relief. With offices in Mesa, the law firm serves Arizona residents in the greater Phoenix area, including Scottsdale, Mesa, Tempe, Gilbert, and Chandler. As a client-oriented law firm with a mission to always exceed client expectations, the Pew Law Center has helped over 2,000 people file for bankruptcy and eliminate over \$100 Million in debt.

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