

CANCELED DEBTS AND MORTGAGE DEBT FORGIVENESS

If you borrow money from a commercial lender and the lender later cancels or forgives the debt, you may have to include the canceled amount in income for tax purposes. When you borrowed the money you were not required to include the loan proceeds in income because you had an obligation to repay the lender. When that obligation is subsequently canceled (i.e. forgiven), the amount you received as loan proceeds is normally reportable as income because you no longer have an obligation to repay the lender. The lender is usually required to report the amount of the canceled debt to you and the IRS on a Form 1099-C, Cancellation of Debt unless you meet one of the exceptions or exclusions discussed below.

As an example, suppose you borrow \$10,000 and default on the loan after paying back \$2,000. If the lender is unable to collect the remaining debt from you, there is a cancellation of debt of \$8,000, which generally is taxable income to you.

There are common situations when this debt can be excluded from income. The following summarizes some common examples of exemptions and exclusions of canceled debt from income:

Qualified Principal Residence Indebtedness

This is the exception created by the Mortgage Debt Relief Act of 2007 and applies to most homeowners. You can exclude canceled debt from income if it is qualified principle residence indebtedness which is a defined term that basically provides for a homeowner to exclude certain cancelled debt on their principal residence from income. The Act applies only to forgiven or cancelled debt used to buy, build or substantially improve your principal residence, or to refinance debt incurred for those purposes.

Qualified Real Property Business Indebtedness

This exception allows you to elect to exclude canceled qualified real property business indebtedness from income. Qualified real property business indebtedness is debt which is incurred or assumed in connection with real property used in a trade or business, the debt is secured by the real property, and the property was purchased before January 1, 1993, or on or after that date if the proceeds were used to acquire, construct, or substantially improve real property.

Bankruptcy:

Debts discharged through bankruptcy are not considered taxable income. The cancellation of the debt must be granted by the bankruptcy court or must occur as a result of a plan approved by the bankruptcy court. To show that your debt was cancelled in a bankruptcy case is excluded from income, attach Form 982 to your federal income tax return.

Insolvency

If you are insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable to you. You are insolvent when your total debts are more than the fair market value of your total assets. Similarly to the Bankruptcy exemption, you should attach Form 982 to your federal income tax return. Consulting with a professional to help determine and calculate the extent of your insolvency immediately before the cancellation is highly advisable.

Non-recourse loans

A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue you personally in case of default. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in cancellation of debt income. However, it may result in other tax consequences beyond the scope of this article.

Also to the extent that a loan from a lender is not fully satisfied and a lender cancels the unsatisfied debt, which is typically referred to as a Short Sale, you have cancellation of indebtedness income. If the amount forgiven or canceled is \$600 or more, the lender must generally issue Form 1099-C, Cancellation of Debt, showing the amount of debt canceled. However, you may be able to exclude part or all of this income if the debt was qualified under one of the exceptions and exclusions discussed above. Please also note that Nonbusiness credit card debt cancellation can be excluded from income if the cancellation occurred in a bankruptcy case, or to the extent you were insolvent just before the cancellation. It is advisable to meet with your Attorney or a Tax Professional to discuss these options in further detail.

Lance T. Denha, of Denha & Associates, PLLC, works in the areas of business transactional law, foreclosure/preforeclosure workouts and bankruptcy law. In the business area, he specializes in general corporate law with a concentration in business and commercial transactions, property tax appeals, health care, and liquor licensing matters. In the foreclosure/preforeclosure workouts legal arena, Mr. Denha represents borrowers against lenders in seeking out residential loan workouts for purposes of avoiding foreclosure, or in the alternative, Mr. Denha will represent borrowers in foreclosure defense cases against lenders. Lastly, in the bankruptcy area, Mr. Denha's focus is on bankruptcy law matters, specializing in debtor representation, creditor relations, and related litigation.

Mr. Denha is a member of the State Bar of Michigan and State Bar of Florida where he is licensed to practice law in Michigan and Florida.