Mortgage Forgiveness Debt Relief Act

Consequences of the expiration of the act

Cancellation of Debt (COD) Income

- When a loan is forgiven without being paid back, COD Income is created.
- That amount is included in the income of the person for whom the debt was cancelled, and that person will have to pay taxes on the income.
- In certain situations, that cancelled debt can be excluded from income.

Recourse Loan

- A recourse loan is a loan where borrower is personally liable. The lender can go after the borrower's personal property even after the collateral has been taken.
  - If a borrower owes $150,000 on a house worth only $100,000, and the lender forecloses, the lender can go after the borrower's other assets to satisfy the remaining $50,000 of the loan.
  - However, if the lender chooses to cancel the remaining debt, COD Income is created.

Non-Recourse Loan

- A non-recourse loan is a loan where the buyer is not personally liable. The lender can only seek to recover the collateral in satisfaction of the debt.
  - If a borrower defaults on a non-recourse home loan for $150,000, the bank can only seek to recover the collateral, which is the house, even if that does not fully satisfy the debt.

Anti-Deficiency Statute

- A.R.S. § 33-814 is Arizona's anti-deficiency statute.
- It provides that a lender has no recourse against a borrower if:
  - The property is 2.5 acres or less.
  - Utilized for a single one or two family dwelling.
  - The loan was a purchase money loan.

Gain

- Sale price/FMV > debt/basis resulting in capital gain.
- Generally, there is no tax liability on gain under the primary residence exception for $250,000 in gain if you reside in the home for at least two years with a sale after 5 years.
- 1099-S: voluntary sale

1099-S

- For sales or exchanges of certain real estate, the person responsible for closing a real estate transaction must report the real estate proceeds to the Internal Revenue Service (as a 1099-S) and must furnish this statement to you.

1099-A

- Certain lenders who acquire an interest in property that was security for a loan or who have reason to know that such property has been abandoned must provide you with this statement in the form of a 1099-S.
- You may have reportable income or loss because of such acquisition or abandonment.
- Gain or loss from an acquisition generally is measured by the difference between your adjusted basis in the property and the amount of your debt canceled in exchange for the property, or, if greater, the sale proceeds.
- If you abandoned the property, you may have income from the discharge of indebtedness in the amount of the unpaid balance of your canceled debt. The tax consequences of abandoning property depend on whether or not you were personally liable for the debt. Losses on acquisitions or abandonments of property held for personal use are not deductible.
- See IRS Pub. 4681 for information about your tax consequences

1099-A

- This is the form issued by the lender when the lender acquires an interest in the secured property, or has reason to know that you have abandoned the property.
- The lender reports the principal balance of the debt owed and the fair market value.
- The debtor determines gain or loss based on the values provided.
- If the property is foreclosed, or there is a deed in lieu of foreclosure, and there is no debt cancelled, the lender will provide a 1099-A.

Example: 1099-A with Gain

- A buyer purchases a home for $100,000 in 2005. In 2007, he takes out a home equity loan of $50,000 to purchase a car. Both loans are non-recourse. In 2009, the buyer loses his job and can no longer make payments on the house. He owes $140,000 on the loan, and the fair market value of the property is $125,000. The lender forecloses on the house in satisfaction of both loans.
- The buyer will receive a 1099-A with the amount of the loan showing as $140,000 and the fair market value as $125,000. The buyer will need to calculate gain or loss.
- Gain= $140,000 - $100,000; Gain=$40,000
- The $40,000 gain is taxable and must be included in income

Example: 1099-A with Loss

- A buyer purchases a home in 2007 for $200,000 with a non-recourse loan. In 2012, the buyer stops making payments when the remaining loan balance is $150,000 and the fair market value is $125,000. The lender forecloses in satisfaction of the loan.
- The buyer will receive a 1099-A with the balance of the loan as $150,000 and the fair market value as $125,000. The buyer will need to calculate gain or loss.
- Loss=$200,000 - $150,000; Loss=$50,000
- The buyer has a loss of $50,000, but may not take a deduction because it is a personal loss

Mortgage Forgiveness Debt Relief Act

- In 2007, Congress passed the Mortgage Forgiveness Debt Relief Act.
- The Act added indebtedness that is cancelled/forgiven from a primary residence prior to January 1, 2014 to the list of situations where COD Income was excluded from income (See IRC § 108(a)(1)(E)).
- The exclusion is limited to $2 million ($1 million for a married individual filing a separate return).

Qualifying Debt

- Only qualifying debt that is cancelled can be excluded from income.
- Qualifying debt is:
  - Acquisition indebtedness, which is indebtedness incurred in the acquisition, construction, or substantial improvement of the principal residence, and is secured by the residence.
  - Acquisition indebtedness that is refinanced, to the extent that the amount refinanced does not exceed the refinanced indebtedness.
- If a loan is cancelled/forgiven, and only a portion of the loan is qualifying principal residence indebtedness, the exclusion will only apply to the extent that the amount cancelled exceeds the amount of the loan that is not qualifying debt.

Example

- A buyer purchases a house for $200,000. He later takes out a home equity loan for $50,000 to purchase a vehicle. The home equity loan is not qualifying principal residence indebtedness because the cash taken out was not used to acquire, construct, or substantially improve the principal residence.

Example

- Assume that in the above situation, the lender forecloses on the home. It is worth $210,000, the buyer still owes $240,000, and the lender cancels/forgives the $30,000 remaining balance.
- The amount cancelled ($30K) does not exceed the amount attributable to non-qualifying principal residence indebtedness ($50K – the home equity loan used to purchase a vehicle) so the amount may not be excluded from income.
- $240,000 – $210,000= $30,000 remaining debt
- $30,000 – $50,000=$0 that may be excluded

Foreclosure & Deed in Lieu of Foreclosure

- Both a foreclosure and a deed in lieu of foreclosure are considered a sale for tax purposes.
- This is called a realization event, and it requires the calculation of gain or loss, which is the amount realized minus the adjusted basis.
- In order to calculate gain or loss, the adjusted basis and the amount realized must be determined.

Adjusted Basis

- Adjusted basis is essentially what you paid for your home, increased or decreased by any qualifying events.
- Basis is necessary for calculating whether there was a gain or loss on the sale or other disposition of property.
- A qualifying event that will increase basis is an improvement that adds value to the property, such as building on another room to a house
- A qualifying event that will decrease basis is an insurance payout for a casualty loss, such as a fire

Amount Realized

- The amount realized depends on two factors:
  - Whether the loan is a recourse loan or a non-recourse loan.
    - Recourse – Amount realized is the fair market value.
    - Non-Recourse – Amount realized is the total cancelled debt.
  - Whether the sale was a foreclosure or a deed in lieu of foreclosure.
    - Foreclosure – Fair market value is presumed to be the bid amount.
    - Deed in lieu of foreclosure – Fair market value is the appraised amount.

Example: Foreclosure with Recourse Loan

- A buyer purchases a home in 2005 with a $200,000 recourse mortgage, and lives there until the lender forecloses in 2009. The buyer still owes $175,000 on the loan at the time of the foreclosure, but the fair market value of the house is only $150,000. If the lender accepts the property in full satisfaction of the loan, the buyer has a loss of $50,000 ($200,000 adjusted basis minus $150,000 amount realized) and COD Income of $25,000.
- Loss=$200,000 – $150,000; Loss=$50,000
- $175,000 – $150,000 = $25,000 cancelled/forgiven loan balance

Example: Foreclosure with a non-recourse loan

- A buyer purchases a home in 2005 with a $200,000 non-recourse mortgage, and lives there until the lender forecloses in 2009. The buyer still owes $175,000 on the loan at the time of the foreclosure, but the fair market value of the house is only $150,000.
- The lender must accept the property in full satisfaction of the loan because it is non-recourse, the buyer has a loss of $25,000 ($200,000 adjusted basis minus $175,000 amount realized) and there is no COD Income.
- Loss=$200,000 – $175,000; Loss=$25,000

Under the Act

- The act helped homeowners who were hit hard enough by the recession to lose their home, which resulted in COD income.
  - Recourse loans result in COD Income for any amount above the fair market value of the home that is cancelled.
  - A loan modification, which is an adjustment to the principal balance to allow a buyer to continue to make payments, also results in COD Income.
- The act did not do much for homeowners with non-recourse loans because non-recourse loans do not result in COD Income.

2014 and Beyond

- Holders of non-recourse mortgages will still be able to attempt to exclude any cancelled debt under IRC § 121, since all the cancelled debt is included for the gain or loss calculation.
- Holders of recourse loans will no longer be able to exclude their cancelled debt from income under the exception for qualified principal residence indebtedness.
- Instead, in order to exclude the cancelled debt, the buyer will need to be insolvent, or will be forced to file bankruptcy.

Insolvency

- Amount of insolvency = Total debts owed > Total value of assets
- This is calculated immediately before the debt is cancelled

Example

- Buyer purchases a home for $200,000 in 2009, borrowing the entire purchase price. He loses his job in 2013 and decides to abandon the property. The loan balance is $185,000 and the fair market value of the property is $150,000. The bank forecloses and sells the house at a foreclosure sale in 2014.

Example: Continued

- If the loan was a recourse loan:
  - The buyer will receive a 1099-A for 2014, since that is when the foreclosure sale occurred. It will list the balance of the debt owed as $185,000 and the fair market value of $150,000.
  - Loss=$200,000 - $150,000; Loss=$50,000
  - For 2014, the buyer will have a loss on the home of $50,000
  - If the lender forgives the remaining amount of the loan, the buyer will have COD Income of $35,000. In this case, a 1099-C will replace the 1099-A.

Example: Continued

- If the loan was a non-recourse loan:
  - The buyer will receive a 1099-A for 2013. It will list the balance of the debt owed as $185,000 and the fair market value of $150,000.
  - The buyer must calculate his gain of loss for 2013, even though the foreclosure sale did not occur until 2014.
  - Loss=$200,000 –$185,000; Loss=$15,000
  - Since the loan was non-recourse, there is no COD Income.

1099-C

- The form sent by the IRS where there is cancellation of debt income.
- Required where (1) there is debt cancelled of $600 or more, and (2) the lender is a financial institution, credit union, a federal government agency, any organization that has a significant trade or business lending money.
- If there is COD Income in connection with an abandonment, the lender can include information about the abandonment on form 1099-C.

Putting it all together

- John and Mary purchase a home in 2005 for $335,000, taking out a recourse loan for $320,000, secured by the home. In 2013, they are no longer able to make their loan payments. They are insolvent by $11,500. The outstanding loan balance is $315,000 and the fair market value is $290,000. The lender forecloses on the home in satisfaction of the loan. John and Mary will receive a 1099-C showing cancelled debt of $25,000 ($315,000 loan balance - $290,000 fair market value).

John and Mary's 1099-C

CREDITOR'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no.
Birch Bank
76 Spruce Lane
Treetown, KS 00000

1 Date of identifiable event: 3-1-2013
2 Amount of debt discharged: $25,000.00
3 Interest if included in box 2: $

OMB No. 1545-1424
2013
Form 1099-C

Cancellation of Debt

CREDITOR'S federal identification number: 10-7890123
DEBTOR'S identification number: 234-00-7890

4 Debt description: Home mortgage loan

Copy B
For Debtor

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.

DEBTOR'S name: John and Mary Elm

Street address (including apt. no.): 11 Siberian Street

City or town, province or state, country, and ZIP or foreign postal code: Treetown, KS 00000

5 If checked, the debtor was personally liable for repayment of the debt . . . . ▶ ☑

Account number (see instructions): 505050

6 Identifiable event code: D

7 Fair market value of property: $290,000.00

Date debt was canceled (mm/dd/yy)		03/01/13
Part I. Total liabilities immediately before the cancellation (do not include the same liability in more than one category)		
	Liabilities (debts)	Amount Owed Immediately Before the Cancellation
1.	Credit card debt	$ 5,500
2.	Mortgage(s) on real property (including first and second mortgages and home equity loans) (mortgage(s) can be on personal residence, any additional residence, or property held for investment or used in a trade or business)	$ 315,000
3.	Car and other vehicle loans	$
4.	Medical bills owed	$
5.	Student loans	$
6.	Accrued or past-due mortgage interest	$
7.	Accrued or past-due real estate taxes	$
8.	Accrued or past-due utilities (water, gas, electric)	$
9.	Accrued or past-due child care costs	$
10.	Federal or state income taxes remaining due (for prior tax years)	$
11.	Judgments	$
12.	Business debts (including those owed as a sole proprietor or partner)	$
13.	Margin debt on stocks and other debt to purchase or secured by investment assets other than real property	$
14.	Other liabilities (debts) not included above	$
15.	Total liabilities immediately before the cancellation. Add lines 1 through 14.	$ 320,500
Part II. Fair market value (FMV) of assets owned immediately before the cancellation (do not include the FMV of the same asset in more than one category)		
	Assets	FMV Immediately Before the Cancellation
16.	Cash and bank account balances	$ 6,000
17.	Real property, including the value of land (can be main home, any additional home, or property held for investment or used in a trade or business)	$ 290,000
18.	Cars and other vehicles	$
19.	Computers	$
20.	Household goods and furnishings (for example, appliances, electronics, furniture, etc.)	$
21.	Tools	$
22.	Jewelry	$
23.	Clothing	$
24.	Books	$
25.	Stocks and bonds	$
26.	Investments in coins, stamps, paintings, or other collectibles	$
27.	Firearms, sports, photographic, and other hobby equipment	$
28.	Interest in retirement accounts (IRA accounts, 401(k) accounts, and other retirement accounts)	$ 13,000
29.	Interest in a pension plan	$
30.	Interest in education accounts	$
31.	Cash value of life insurance	$
32.	Security deposits with landlords, utilities, and others	$
33.	Interests in partnerships	$
34.	Value of investment in a business	$
35.	Other investments (for example, annuity contracts, guaranteed investment contracts, mutual funds, commodity accounts, interests in hedge funds, and options)	$
36.	Other assets not included above	$
37.	FMV of total assets immediately before the cancellation. Add lines 16 through 36.	$ 309,000
Part III. Insolvency		
38.	Amount of Insolvency. Subtract line 37 from line 15. If zero or less, you are not insolvent.	$ 11,500

Under the Act

- Under the Act, there is an exclusion for COD Income for qualified principal residence indebtedness.
- The indebtedness is qualified because:
  - The indebtedness is from acquiring the home.
  - It is secured by the home.
- The qualified principal residence indebtedness exception will allow the buyer to exclude the entire amount ($25,000) from income.
- The buyer must also calculate gain or loss
- Loss= $335,000 - $290,000; Loss=$45,000

After Expiration of the Act

- There is no exclusion of COD Income for qualified principal residence indebtedness, so the buyer will be taxed on the COD Income.
- The buyer can exclude some of the COD Income due to insolvency, but that is limited to the amount of insolvency, here $11,500.
- The remaining $13,500 of COD Income must be included in the buyer's income.
- Loss=$335,000-$290,000; Loss=$45,000