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Tax consequences from discharge of indebtedness

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The Mortgage Forgiveness Debt Relief Act of 2007 provides for individuals to exclude from gross income any discharges occurring after 2006 and before 2010 on qualified principal residence indebtedness. The maximum amount that can be excluded is $2 million, or $1 million if married filing separately. Prior to this act, any mortgage workouts that involved debt reductions to solvent taxpayers would result in cancellation of debt income being reported on the taxpayers return in the year of forgiveness.

This exclusion is intended to allow taxpayers that got in over their heads with creative mortgage financing, or who were victims to a rapid decrease in the fair market value of their homes, to retain their residences after the lender agreed to new terms. The forgiveness applies only to qualified principal residence indebtedness, defined as a mortgage obtained to buy, build or substantially improve your principal residence. This definition includes any additional debt incurred by the taxpayer and secured by the real estate, but only if the proceeds were used to improve the residence.

While all this sounds fantastic, there are some tax pitfalls. First, the amount of debt forgiven is excludable only up to the taxpayer's basis in the residence. The balance of the forgiveness in excess of the basis is income. Also, the forgiveness reduces the basis in the residence which is reflected on the personal tax return on Form 982. This basis reduction could then lead to future taxable income if the selling price exceeds the sum of the residential gain exclusion plus the revised adjusted basis of the property. In addition, debt forgiveness from recourse loans, vacation homes or home equity loans not used for home improvements remain taxable.

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