

## Know the Details of the Mortgage Forgiveness Debt Relief Act

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*Home-selling Strategies by Chris Kaucnik and Michael J. Greenen*

RISMEDIA, Dec. 2, 2008 - No matter the circumstances, there's a lot of stress a homeowner goes through in a foreclosure or a short sale.

### Brief Background

Prior to December 2007, if a homeowner lost his house due to a bank foreclosure, and the bank forgave any difference between the price it was sold for and what was owed, the homeowner would owe additional income tax on that portion. Yes, it's hard to believe, but true.

Let's say the homeowner owed \$300,000 on the mortgage, but the foreclosure sale only brought in \$200,000. Then the bank forgave the \$100,000 shortfall. The homeowner would have been liable for the income tax on the \$100,000 debt forgiveness from the bank.

The IRS considered this money effectively paid to the homeowner, and it would be taxable in their top bracket.

Now, because of the unique stresses in the housing industry lately and on our whole economy, in December 2007, Congress stepped in to provide temporary relief in the form of forgiving this debt, but only for the 2007, 2008 and 2009 tax years. After that, the old rule applies again.

To be eligible for this tax relief, the mortgage must be for your principal residence. It does not apply to vacation, investment or other properties. And no more than \$2 million of forgiven debt can be excluded from taxable income.

### Home Equity Loans

Another very important detail in this temporary tax break is if part of the forgiven debt was a home equity loan and used for purposes other than to build, buy or substantially improve the property, that portion is still taxable. In other words, home equity loans used for vacations aren't included.

### Short Sales

Now, what happens in a short sale? In brief, this can occur when a borrower is behind on the mortgage payments and the lender agrees he can sell his house for less than what is owed on the mortgage. But all proceeds must be turned over to the bank.

The portion of the mortgage the bank forgives, plus any commission expenses or other selling costs, are taxable income if this debt is canceled. Yes, even the commission and selling expenses count.

A homeowner can now receive a \$250,000 (single) and \$500,000 (married) capital gain exclusion on the sale of their primary residence.

Here's an example where the home was originally purchased for \$300,000, there was a \$100,000 debt cancellation, and a married couple is selling the home:

Home Sells for \$750,000  
Less Original Basis\* (\$200,000)  
Less Capital Gain Exclusion (\$500,000)  
Gain on Sale \$50,000  
Capital Gains Tax at 15% \$7500 (Owed by homeowner)

\*This is the original basis or price of home \$300,000, less the \$100,000 debt cancellation from the lender.

While \$7,500 capital gains tax is surely a lot less than the \$100,000 canceled by the lender, the homeowner may not think of this or be aware it could happen down the road, perhaps just prior to retirement. And capital gains taxes are always subject to change.

### **Mortgage Insurance Affected**

It is important to also note this act extended mortgage insurance as an itemized deduction all the way through 2010. Yes, there's a restriction. The mortgage contract has to be entered into between December 31, 2006 and January 1, 2011.

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**Courtesy of JB Goodwin**