1099s And Taxation Of Discharged Debts: What Is Taxable Income?

Under certain common conditions involving borrowers in foreclosure, canceled debt is not considered taxable income.

BY BRIAN R. HAZEL

Members of the default servicing industry often contend with numerous calls, letters and other communications from debtors inquiring about the Form 1099s they have received post-foreclosure concerning taxable income resulting from creditors' discharge of debt(s).

The Internal Revenue Service (IRS) treats cancellation or forgiveness of debt by a creditor as taxable income to the debtor that must be reported by way of a 1099-A or 1099-C. This situation arises when a property is sold in foreclosure for a specified amount less than total debt. The creditor then usually writes off the balance, thereby canceling or "forgiving" the remaining debt, which is taxable income under the tax code.

In the context of judicial foreclosure, this taxable discharge occurs whether the underlying judgment is in rem or in personam. Debt written off or forgiven in connection with a non-judicial foreclosure is also subject to taxation.

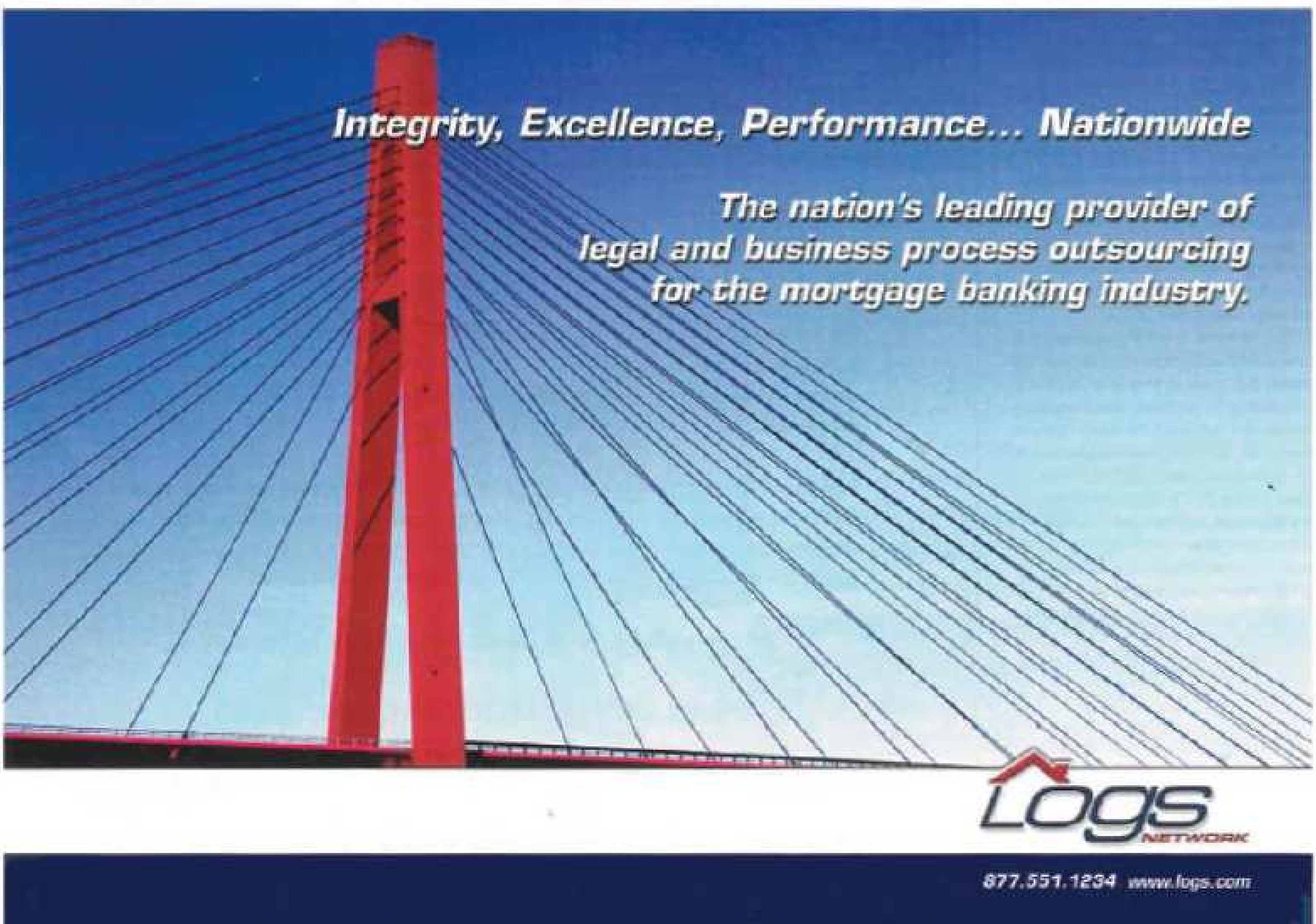
For example, assume a debtor borrows $100,000 and defaults on the loan, leaving a principal balance in the amount of $95,000. The lender forecloses. If the property sells for $90,000, and the lender is unable to collect the remaining debt, there is a cancellation of debt of $5,000, which is taxable income to the debtor(s) and reported to the IRS by way of a Form 1099-A or 1099-C.

Taxation can also result in conjunction with lender-approved loss mitigation. If a debtor in foreclosure sells a house for less than what is owed in a short sale, the difference that is written off by the lender is also treated as discharged debt that is taxable income.

There are, however, several important exclusions to the taxability of a canceled debt, most notably in situations involving the following:

■ Bankruptcy: Debts discharged through bankruptcy are not considered taxable income.

■ Insolvency: If the debtor is insolvent when the debt is canceled, some or all of the canceled debt may not be taxable. The IRS defines a debtor as insolvent when his/her total debts are greater than the fair-



market value of his/her total assets. Because insolvency can be fairly complex to determine, the IRS recommends that debtors obtain the assistance of a tax professional to determine qualification for this exception.

■ Farm debts: If the debt is incurred directly in operation of a farm, more than half the debtor's income for the prior three years was from farming, and the loan was owed to a person or agency regularly engaged in lending, then the canceled debt is generally not considered taxable income.

Again, as the rules applicable to farmers are complex, the IRS recommends that debtors obtain the assistance of a tax professional to determine qualification for this exception.

■ Nonrecourse loans: A nonrecourse 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. Forgiveness of a nonrecourse loan resulting from a foreclosure does not result in cancellation of debt income.

Qualified principal residence

A significant exemption to the taxation of discharged debt was created by the recently passed Mortgage Forgiveness Debt Relief Act of 2007 (H.R.3648). This legislation allows many homeowners to exclude income from the discharge of debt forgiven in connection with foreclosure or mortgage restructuring.

"Families dealing with the pain of a foreclosure should not have the double whammy of a large tax bill for terminating their mortgage through no fault of their own," noted Rep. Charles B. Rangel, D-N.Y., the chairman of House Ways and Means Committee.

H.R.3648 creates a $2 million exclusion ($1 million for debtors filing separately) for personal debts canceled in 2007, 2008 or 2009 if the debt was secured by the debtor's "qualified principal residence."

The IRS defines "qualified principal residence" as the indebtedness used to buy, build or substantially improve the debtor's principal residence, and it must have been secured by that residence. Debt used to refinance qualifying debt is also eligible for the exclusion, but only up to the amount of the old mortgage principal, just before the refinancing.

The exemption created by the act can be used by filing a Form 982 to reduce a filer's tax attributes resulting from discharge of debts. The form can be filed with the federal tax return or filed as part of an amended return within six months of the due date of the original return.

Debt forgiven on second homes, rental property, business property, credit cards or car loans does not qualify for the new tax-relief provision. Other exemptions, such as insolvency, may apply. However, it is the debtor's duty to investigate these options. Form 982 contains additional details for applying for these exemptions.

The Mortgage Forgiveness Debt Relief Act of 2007 also creates a three-year window for homeowners to refinance a mortgage and pay no taxes on any debt forgiveness that they receive. Under the prior law, if the value of a refinancing debtor's house declines, and the bank or lender forgives a portion of the debt, the tax code treats the amount forgiven like any other discharged debt and taxes the amount forgiven as income.

"When your home is losing value and your family is under financial stress, the last thing you need is to be hit with higher taxes," President George W. Bush explained. "So I'm working with members of both parties to pass a bill that will protect homeowners from having to pay taxes on canceled mortgage debt."

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Brian R. Hazel is a foreclosure attorney with Kansas- and Missouri-based law firm South & Associates PC. He can be contacted at (913) 663-7600.

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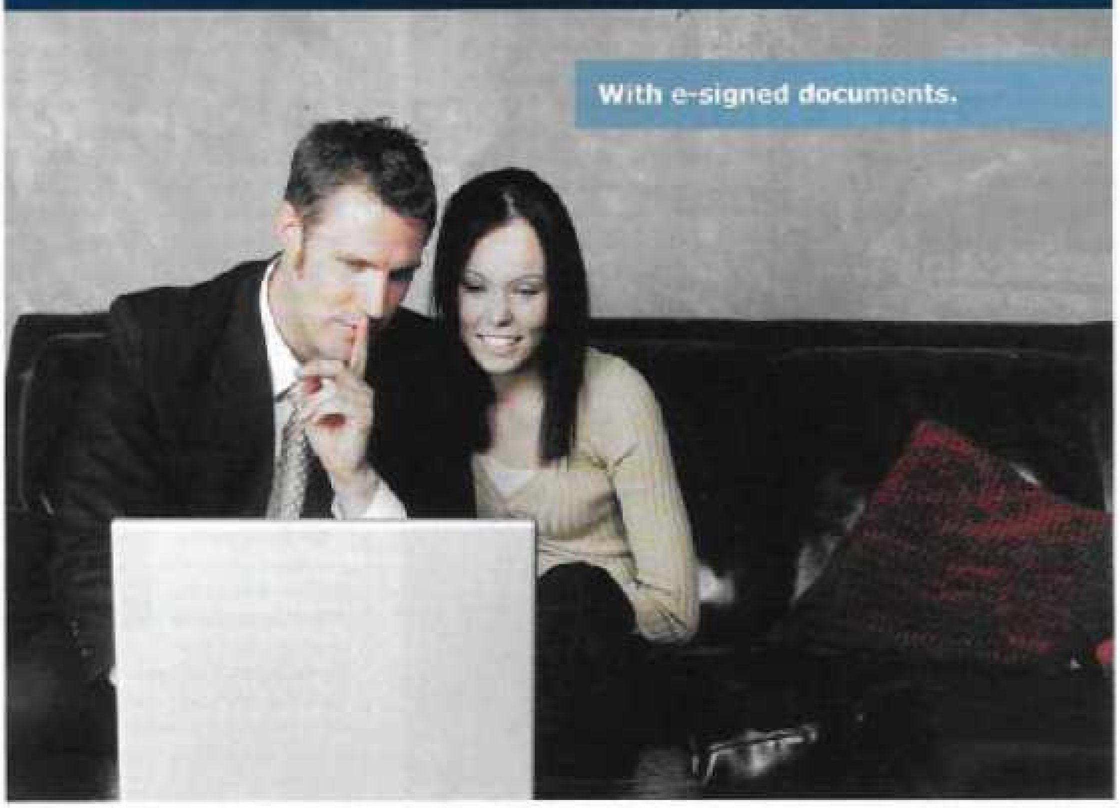

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Adjustable rate mortgages (ARMs) are re-setting at an alarming rate, and savvy servicers are looking for innovative ways to streamline this process, while also reducing associated expenses. ClosingStream, Fidelity National Information Services' (FIS) LSI division's self-service e-signature loan-modification solution provides servicers with the most effective and secure method for getting documents executed, while keeping their ARM re-set servicing costs to a minimum.

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Will - or even should - the results of this test convince servicers to stop using BPOs? Of course not: BPOs are the product of choice of the servicing industry and will be for the foreseeable future.

But what this test does suggest is that AVMs and BPOs used together can improve the quality and the depth of information that a servicer has in making a decision.

For instance, if the typical property has two or three valuation reviews as it moves from default through foreclosure to REO, should they all be BPOs? Maybe, but by adding a default AVM into the mix, the servicer obtains not only a different perspective on the disposition value, but also much deeper information on the property and its ownership history, neighborhood, area listings and sales, maps and more.

Large users of BPOs are also beginning to see the value of using default AVM technology to evaluate the effectiveness of their BPO providers. A test like the one we conducted, for example, could give a national servicer a much better understanding of the performance levels of their BPO providers in different markets.

Finally, a number of servicers are now using AVMs for quality assurance and fraud detection, running AVMs against recent re-sales of REO properties. Typically, for every thousand loans reviewed for BPO price, the final REO sales price and a second sale price, four or five properties that have re-sold at a significantly higher price will be found a few months later. This discrepancy is often a sign of collusion and fraud.

In conclusion, the important question should not be whether BPOs are better than AVMs, or vice versa, but instead, whether we as an industry are using all of the available tools to work through the servicing challenges we face. SM

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According to a White House press release, "This Act will increase the incentive for borrowers and lenders to work together to refinance loans and allow American families to secure lower mortgage payments without facing higher taxes."

More efforts

In addition, the Bush administration has urged Congress to modernize the Federal Housing Administration (FHA) to give the FHA greater flexibility in order to qualify more homebuyers for prime-rate financing. Bush has also encouraged the legislature to reform and strengthen independent regulation of government-sponsored enterprises (GSEs), such as Freddie Mac and Fannie Mae, to improve efficiency and ensure that GSEs continue to focus on "their important housing mission."

Given all of these developments, here are some helpful forms and links to provide inquiring debtors, lenders, servicers or attorneys:

■ Questions and Answers on Home Foreclosure and Debt Cancellation: http://www.irs.gov/newsroom/article/0,,id=174034,00.html

■ Instructions for Forms 1099-A and 1099-C (2008): http://www.irs.gov/instructions/i1099ac/index.html

■ Form 982: Reduction of Tax Attributes Due to Discharge of Indebtedness: http://www.irs.gov/pub/irs-pdf/f982.pdf

Finally, while foreclosure firms' representation of lenders does not usually extend into the possible tax repercussions that debtors in foreclosure face, education about these issues and responding appropriately to debtors' inquiries may assist in insulating both firms and lenders from unnecessary scrutiny or exposure.

It is also important to note that the IRS encourages debtors who disagree with the information contained in a Form 1099 to contact the lender and request a corrected form (if the information is determined to be incorrect). SM