

Mortgage Debt Relief & Cancellation of Debt Income

If you owe a debt to someone else and they cancel or forgive that debt, the canceled amount may be taxable.

Mortgage Debt Relief

The Mortgage Debt Relief Act of 2007 generally allows taxpayers to exclude income from the discharge of debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief.

This provision applies to debt forgiven in calendar years 2007 through 2012. Up to \$2 million of forgiven debt is eligible for this exclusion (\$1 million if married filing separately). The exclusion does not apply if the discharge is due to services performed for the lender or any other reason not directly related to a decline in the home's value or the taxpayer's financial condition.

The Act applies only to forgiven or canceled debt used to buy, build or substantially improve your principal residence, or to refinance debt incurred for those purposes. In addition, the debt must be secured by the home. This is known as qualified principal residence indebtedness. The maximum amount you can treat as qualified principal residence indebtedness is \$2 million or \$1 million if married filing separately.

Cancellation of Debt Income

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, depending on the circumstances. 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 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. Cancellation of Debt income is not always taxable; there are some exceptions, such as qualified principle residence indebtedness, mentioned above.

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