

SPECIAL ARTICLE ON THE MORTGAGE DEBT RELIEF ACT

December 31, 2012 is fast approaching and that means the end of some important legislation. One of the most important pieces of legislation for investors and owners in Arizona is the Mortgage Forgiveness Debt Relief Act and Debt Cancellation. While many political pundits argue that the Act will be extended another year or longer, since it's impossible to know what to do, many people are taking proactive steps prior to the year's end.

When a person loses their home through a short sale, foreclosure or deed-in-lieu, they don't feel like they receive any windfall, but the IRS disagrees. From the IRS perspective, if a homeowner took out a loan and the lender cancels the debt, the balance is no longer owed. The IRS considers this to be income, and the lender is required to file a 1099-C form, entitled Cancellation of Debt, identifying the amount forgiven. What started out as a loan that was to be repaid, is now simply income because the owner received the money but isn't liable to pay it back. As income, the owner is liable to pay taxes in the year in which the lender cancels the debt. This is often referred to as "phantom income," and can be an unwelcome surprise for homeowners doing their taxes.

There are some exceptions to when a forgiven debt will be charged as phantom income. For example, if a taxpayer is considered legally insolvent (when their assets are less than their total debts, but no requirement of bankruptcy) some or all of the debt may not be taxable. Additionally, a cancellation of a debt from a non-recourse loan is not taxable as discussed below. Another exception was created in 2007 in the Mortgage Debt Forgiveness Act (MDFA or the Act). The Act provides that debt cancellation on a taxpayer's "qualified principal residence" will not give rise to taxable income. It applies to cancelled debts used to buy, build or improve a person's principal residence or a refinance of a loan for that purpose. This does not include an investment property. The maximum amount that can qualify is \$2 million or \$1 million when married couples file separately. The Act applies to debt forgiven in the calendar years 2007 – 2012. While unclear, it appears to mean that the transaction (short sale, foreclosure) must be *completed* before the end of the year, not simply be in the process.

The debt forgiven must be reported to the IRS, but it's not *currently* taxable. If, however, the Act is permitted to expire, then the exception would no longer apply and taxpayers would be liable for taxes on the forgiven debt. Therefore, if a homeowner took out a \$450,000 loan, and the home short sold for \$300,000, they may receive a tax bill on \$150,000 in phantom income. Because it is not clear whether an extension will be enacted, nor whether the transaction must actually be completed or simply undertaken by year's end, many homeowner's are using this time period to push to conclude such transactions. For example, a homeowner seeking a short sale, would be wise to follow up

with their bank and avoid delays in attempting to get short sale approval and close escrow.

One final note, as mentioned above, an exception exists to the taxable income for nonrecourse loans. A nonrecourse loan is a loan in which the lender can only pursue the property and not the amount of the promissory note. The IRS states that forgiveness from a nonrecourse loan does not result in debt income because the lender never had the right to receive the balance of the loan, only to recover the property. Some people argue Arizona's anti-deficiency statute actually makes qualifying home loans nonrecourse, because by law the lender cannot pursue a homeowner for a deficiency in certain situations. (This of course is a question for a CPA, not an attorney.) The Arizona law provides that after a trustee's sale, a lender cannot pursue the owner for a deficiency judgment regarding a property that is two and one-half acres or less and is limited to and utilized as a single one-family or single two-family dwelling. This is the non-recourse language. It applies to all real property, not only the owner's principal residence, and therefore protects investors. While the statute does apply to deficiency resulting from trustee's sale, it does not apply to short sales or deed-in-lieu.

Because of these uncertainties, homeowners should talk to their attorneys' and accountants to discuss how to resolve their tax issues for this year. Once the decisions have been made in Washington, I will provide an update in a 2013 AZREIA newsletter.

