

Addressing the subprime lending crisis, Congress recently passed and the President signed into law a new measure giving tax breaks to homeowners who have mortgage debt forgiven. Under preexisting law, the debt forgiven by a lender, such as for short sales and refinances, was generally taxable to the borrower as debt discharge income. With the passage of the Mortgage Forgiveness Debt Relief Act of 2007, a taxpayer does not have to pay federal income tax on up to \$2 million of debt forgiven for a loan secured by a qualified principal residence. The change in the tax law applies to debts discharged from January 1, 2007 to December 31, 2009. Here are the details.

Discharge of indebtedness income: background.

For income tax purposes, a discharge of indebtedness—that is, a forgiveness of debt—is generally treated as giving rise to income that's includible in gross income. However, a discharge of indebtedness doesn't give rise to gross income if it: (1) occurs in a Title 11 bankruptcy case, (2) occurs when the taxpayer is insolvent, (3) is a discharge of qualified farm indebtedness, or (4) is a discharge of qualified real property business indebtedness.

Under pre-2007 Mortgage Relief Act law, there were no special rules applicable to discharges of acquisition debt on the taxpayer's principal residence. For example, assume a taxpayer who isn't in bankruptcy and isn't insolvent owns a principal residence subject to a \$200,000 mortgage debt for which the taxpayer has personal liability. The creditor forecloses and the home is sold for \$180,000 in satisfaction of the debt. Under pre-2007 Mortgage Relief Act law, the debtor had \$20,000 of debt discharge income. The result was the same if the creditor restructured the loan and reduced the principal amount to \$180,000.

New law relief provision.

The 2007 Mortgage Relief Act excludes from a taxpayer's gross income any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness before Jan. 1, 2010. The exclusion applies where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure. For example, assume the same facts as in the example above except that the discharge occurs in 2008. Under the 2007 Mortgage Relief Act, the debtor has no debt discharge income when the creditor (1) restructures the loan and reduces the principal amount to \$180,000 or (2) forecloses with the result that the \$200,000 debt is satisfied for \$180,000.

Here is some of the critical fine print in this new relief provision:

- The tax relief applies to the original purchase price, plus improvements, of the taxpayer's principal residence. It doesn't apply to discharges of second mortgages or home equity loans, unless the loan proceeds were used to acquire, construct, or substantially improve the taxpayer's principal residence. Refinanced indebtedness qualifies to the extent it doesn't exceed the amount of indebtedness being refinanced. (Cash out from refinancing doesn't qualify for the exclusion.)
- The indebtedness must be incurred with respect to the taxpayer's principal residence only. The exclusion rule doesn't apply to second homes, vacation homes, business property, or investment property, since these properties aren't the taxpayer's principal residence.
- The relief provision is not a permanent fixture of the tax code. It only applies to forgiveness during 2007, 2008, or 2009.
- Nontaxable forgiven mortgage debt is capped at \$2 million (\$1 million for married individuals filing separately).

- When the relief provision applies, the basis of the individual's principal residence is reduced by the amount excluded from income. As a result of this basis reduction rule, the discharged indebtedness is, at least technically, subject to taxation at a later time, when the taxpayer sells or exchanges the principal residence. However, in many cases the reduction won't result in any additional tax, because any gain on that sale or exchange will qualify for the \$250,000 (\$500,000 for married couples filing jointly) home-sale exclusion.