WIPFLI CPAs and Consultants

IMPACT MAGAZINE

How the Mortgage Forgiveness Debt Relief Act Is Helping Homeowners

February 01, 2008

On December 18, 2007, Congress passed the Mortgage Forgiveness Debt Relief Act of 2007 (Mortgage Debt Relief Act), providing some major assistance to certain homeowners struggling to make their mortgage payments.

The centerpiece of the new law is a three-year exception to the long-standing rule under the Tax Code that mortgage debt forgiven by a lender constitutes taxable income to the borrower.

However, the new law does not alleviate all the pain of all troubled homeowners but, in conjunction with a mortgage relief plan recently announced by the Treasury Department, the Act provides assistance to many subprime borrowers.

Cancellation of debt income

When a lender forecloses on property, sells the home for less than the borrower's outstanding mortgage debt and forgives all, or part, of the unpaid debt, the Tax Code generally treats the forgiven portion of the mortgage debt as taxable income to the homeowner. This is regarded as "cancellation of debt income" (reported on a Form 1099) and taxed to the borrower at ordinary income tax rates.

Example. Mary's principal residence is subject to a $250,000 mortgage debt. Her lender forecloses on the property in 2008. Her home is sold for $200,000 due to declining real estate values. The lender forgives the $50,000 difference leaving Mary with $50,000 in discharge of indebtedness income. Without the new exclusion in the Mortgage Debt Relief Act, Mary would have to pay income taxes on the $50,000 cancelled debt income.

The Mortgage Debt Relief Act

The Mortgage Debt Relief Act excludes from taxation discharges of up to $2 million of indebtedness that is secured by a principal residence and was incurred to acquire, build or make substantial improvements to the taxpayer's principal residence. While the determination of a taxpayer's principal residence is to be based on consideration of "all the facts and circumstances," it is generally the one in which the taxpayer lives most of the time. Therefore, vacation homes and second homes are generally excluded.

Moreover, the debt must be secured by, and used for, the principal residence. Home equity indebtedness is not covered by the new law unless it was used to make improvements to the home. "Cash out" refinancing, popular during the recent real estate boom, in which the funds were not put back into the home but were instead used to pay off credit card debt, tuition, medical expenses, or make other expenditures, is not covered by the new law. Such debt is fully taxable income unless other exceptions apply, such as bankruptcy or insolvency. Additionally, "acquisition indebtedness" includes refinancing debt to the extent the amount of the refinancing does not exceed the amount of the refinanced debt.

The Mortgage Debt Relief Act is effective for debt that has been discharged on or after January 1, 2007, and before January 1, 2010.