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Memorandum

TO: TPW

FROM: Sarah A. Nelson

DATE: January 10, 2008

RE: Mortgage Forgiveness Debt Relief Act of 2007

We are writing to inform you that on December 20, 2007, President Bush signed HR 3648 (the “Mortgage Forgiveness Debt Relief Act of 2007” or the “Act”) into law. The Act is designed to protect taxpayers who are facing the possible loss of their homes as a result of foreclosure, presumably due to financial distress, from the additional burden of taxation resulting from the cancellation of their existing debt obligations for less than the full amount of the debt. Prior to the enactment of the Act, a borrower was required to include in gross income the amount of debt forgiven by a lender upon foreclosure or renegotiation of the borrower’s mortgage. The Act is designed to ease the tax burden that arises from this gross income inclusion.

I. Summary

The Act temporarily amends several sections of the Internal Revenue Code of 1986 (the “Code”) which, collectively, require a borrower to take into income any forgiveness of mortgage debt upon foreclosure or renegotiation of the mortgage. Specifically, the Act:

1. excludes from gross income discharged “acquisition indebtedness” that is “qualified principal residence indebtedness” which is discharged before January 1, 2010; and
2. decreases the borrower’s basis in the residence (but not below zero) by the amount of discharged indebtedness.

II. Limitations

A. Acquisition Indebtedness

It is important to note that the Act only excludes from gross income forgiveness of debt that is “acquisition indebtedness”. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the *acquisition, construction, or substantial improvement* of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the refinancing does not exceed the amount of the refinanced indebtedness. *The Act does not exclude from gross income forgiveness of debt in situations, for example, where a borrower has refinanced a mortgage in order to receive cash by increasing the amount of such mortgage (because of an increase in value of the property or by increasing a previously lower “loan to value” ratio) and such cash*

was not applied towards one of the uses mentioned above. Consequently, the Act does not help borrowers who used the proceeds from the loan for purposes other than acquisition, construction, or substantial improvement of their principal residence.

B. Qualified Principal Residence Indebtedness

The Act limits the amount of discharged indebtedness that may be excluded from gross income (“Qualified Principal Residence Indebtedness”) to \$2,000,000 (or \$1,000,000 for married taxpayers filing a separate return). Additionally, the Act does not apply to any discharge that is not directly related to the decline in the value of the residence or to the financial condition of the taxpayer. If only a portion of the amount discharged is Qualified Principal Residence Indebtedness, only the amount discharged that exceeds any amount that is not Qualified Principal Residence Indebtedness (as determined immediately prior to such discharge) may be excluded from gross income.

“Principal residence” has the same meaning as it does in section 121 of the Code, which provides for the exclusion of gain from the sale of a principal residence.¹ The required reduction of a taxpayer’s basis under the Act could result in a taxpayer recognizing gain on a later sale of the home. Such gain may be excluded under the general rules under section 121 of the Code for excluding home sale gain, though (up to \$250,000 for individuals and \$500,000 for married couples filing jointly).²

The provisions described above are in effect for debt that is discharged on or after January 1, 2007 and prior to January 1, 2010.

In addition to the provisions regarding discharge of indebtedness, the Act extends the treatment of mortgage insurance premiums as “qualified residence interest” under section 163(h) of the Code for premiums paid through December 31, 2010.

This memorandum does not address all of the provisions of the Act in detail, including, but not limited to, provisions amending other sections of the Code that do not relate to discharge of indebtedness. Instead, it focuses only on those provisions relating to the forgiveness of mortgage indebtedness. Please contact us if you would like more detailed information regarding other portions of the Act.

To ensure compliance with Internal Revenue Service Circular 230, any United States federal tax advice contained herein, as to which each taxpayer should seek advice based on the

¹ Generally, under section 121 of the Code, a principal residence is a property which is owned and used by the taxpayer as the taxpayer’s principal residence for a period aggregating two years during the five years prior to the date of the sale or exchange (or foreclosure).

² The Act amends section 121 of the Code to allow for the full \$500,000 exemption by a surviving spouse if the principal residence is sold within two years of the death of the deceased spouse.

taxpayer's particular circumstances from an independent tax advisor, is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the United States Internal Revenue Code or (ii) promoting, marketing or recommending to another party the transaction or matters addressed herein.

Please note that we are not members of the Bar of any jurisdiction other than New York and the District of Columbia, and we are not licensed to opine on matters in jurisdictions other than in those states. It should be noted that the authorities administering the laws discussed in this memorandum have broad discretionary powers which may permit such authorities, among other things, to withdraw exemptions accorded by statute and to impose additional requirements not explicitly required by statute.

Please contact Sarah A. Nelson at (212) 912-8342 with any questions.