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Mortgage Forgiveness Debt Relief Act of 2007 Reduces Negative Tax Consequences from Foreclosures

By Tom English and Bill Lathen

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APRIL 2008 - During the recent U.S. real estate boom, some lending institutions abandoned all caution. Lending policies for subprime mortgages became extremely lax. Dubious loans—such as the so-called "Ninja" (no income, no job or assets) loans—became increasingly commonplace. This may be why U.S. homeownership rose from 65% to 69% between 1996 and 2005 (www.census.gov/hhes/www/housing/hvs/qtr307/q307tab5.html).

Rising market values obscured otherwise bad loans. Now that the market has cooled considerably and real estate values have plummeted, the result has been a significant number of foreclosures and an international credit slump. Some subprime lenders, such as New Century Financial, have been driven to bankruptcy (www.ncen.com).

One consequence of these macroeconomic issues is that many subprime borrowers have found themselves with a significant tax liability resulting from the foreclosure on their residence. What follows is a description of such a tax problem that has arisen from the subprime lending and foreclosure issue. The authors detail current efforts to reduce the number of foreclosures, as well as the legislation addressing taxation issues in foreclosure. Finally, they offer suggestions for tax planning.

Subprime Loans and the Foreclosure Problem

Subprime loans were created for potential borrowers with a low credit score, generally in the low 600s or less. Subprime loans carry higher interest rates and often have a prepayment penalty or balloon payment. The rates are high because of normal credit considerations such as credit score, size of down payment, and prior delinquencies. Some loans include a "negative amortization" option, which allows the borrower to pay less than the full amount of interest, causing the loan balance to increase over time. There are problems with adjustable rate mortgages (ARM), loans which offer a low "teaser rate" that adjusts over time. One common type of ARM is a hybrid ARM, which has a fixed rate for a specified period and adjusts thereafter. For example, a 2/1 hybrid ARM has a fixed, usually low, interest rate for the first two years and adjusts each year thereafter to an amount equal to a rate index at the date of the adjustment plus a margin. This margin is often high, resulting in a significant

April 2008 Issue

Enlarge Cover

Features

Striving for Accountability and Sustainability

Meeting of the Minds

Mortgage Forgiveness Debt Relief Act

Editorial: Once Upon a Time ...

More This Issue | Past Issues

increase in the new rate charged to the borrower following the adjustment.

Because of their bad credit history, subprime borrowers may have no choice but to accept these terms; however, they often expect the value of their properties to rise significantly over the initial teaser period, which would allow them to refinance or to reestablish their credit. Some prepayment penalties extend past the two-year period, complicating the refinancing option. Declining real estate prices have made refinancing difficult, resulting in subprime mortgagors being stuck with unmanageable debt service. The *Wall Street Journal* reported on October 24, 2007, that when ARMs "reset," the rates can more than double.

Recent interest-rate cuts by the Federal Reserve may provide some relief, but the problem with foreclosures is still significant. On September 5, 2007, the Federal Deposit Insurance Corporation (FDIC) urged lenders to rework these loans. Sheila Bair, chair of the FDIC, stated: "Reworking these loans will achieve long-term sustainable obligations to provide stability to borrowers, investors, and the marketplace" (www.fdic.gov/news/news/speeches/archives/2007/chairman/spsept0507.html). Some suggestions offered by the FDIC are as follows:

- Modify the terms of the loan or defer payments;
- Convert the loan from an ARM to a fixed-rate loan;
- Extend the loan amortization period; or
- Roll the past-due amount into the principal balance.

President Bush restated his opposition to a federal bailout for this lending crisis, but said administration initiatives will help still-creditworthy homeowners renegotiate their mortgages and remain in their homes (*Wall Street Journal*, December 17, 2007).

It is not clear how many lending institutions will heed the suggestions of the FDIC, or whether the Bush administration's initiatives will reduce the problem, but on October 24, 2007, the *Wall Street Journal* reported that Countrywide expects to restructure nearly $16 billion in response to the problem. The effect this will have on foreclosures is yet to be seen. What is clear is that some 2 million of these ARMs ($229 billion) are due to reset before the end of 2011, indicating a substantial problem.

Tax Problems with Foreclosures

There are many reasons for foreclosure, but the related tax issues are the same. There are two general tax concerns with a foreclosure. First, the foreclosure is considered a disposition of real estate resulting in a realized gain or loss. Second, the foreclosure may become a write-down or write-off of debt resulting in ordinary income [see Treasury Regulations section 1.1001-2(c) ex. 8; Revenue Ruling 90-16, 1990-1 CB 12, and *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir., 1940)]. Because most foreclosures are on personal residences, disposition gains may be excluded and losses disallowed [IRC section 121(a) and (b); IRC section 165(c)]. Debt forgiveness is, however, includable in gross income.

The amount of gain or loss from the deemed disposition is determined by subtracting the basis of the property from the sales price. The first $500,000 gain ($250,000 for taxpayers filing singly) on the sale of real estate used as a personal residence for at least two of the last five years is excluded from income. Conversely, a loss on the sale of a personal residence is disallowed. Thus, gains are generally excluded and losses are disallowed, creating no adverse tax consequences.

Negative tax consequences arise when the deemed selling price is less than the aggregate of the mortgage principal and unpaid interest and penalties. IRC section 61(a)(3) states that gross income includes gains from the sale of property. IRC section 61 (a)(12) indicates that a cancellation of debt (COD) is gross income, separate from gain on the sale of a personal residence. As such, COD is taxable as ordinary income regardless of the gain or loss on a sale.

The problem is exacerbated by the fact that the deemed selling price may be the proceeds of the sale by the mortgage company to a third party subsequent to the foreclosure. Because the selling price from a distress sale may be low and the unpaid interest large, a significant tax problem may result.

Example. Assume that a residential home was purchased in 2005 for $200,000. The value of the home has declined to $180,000 and payments are in arrears. The delinquency has added interest and late fees to the mortgage balance, which is now $198,000. The mortgagee (bank) forecloses on the home and later resells it for $170,000. The result is a nondeductible loss of $30,000 and COD income of $28,000.

Gain/Loss on Sale:

$170,000	Deemed sales price
– $200,000	Cost
$ 30,000	Loss on sale of personal residence (not deductible)

COD Income:

$198,000	Mortgage debt and past-due interest
– $170,000	Deemed selling price
$ 28,000	COD ordinary income

It is clear that the negative tax consequence is the result of two items: the low selling price received by the mortgage company, and the high debt resulting from accrued interest and penalties. The negative consequence is often magnified if the homeowner has both a first and a second mortgage. In this situation, the first mortgagee is concerned only with recouping the investment (the first mortgage and accrued interest), and may be willing to sell at a below-market price. This results in a lower selling price, a greater loss to the second mortgagee, and a greater tax liability for the taxpayer.

In addition, interest and penalties accrue until the financial institution writes off the debt. The debt write-off does not occur

until the property is resold, a personal indemnity suit is settled, and the taxpayer is found unable to pay. The taxpayer will continue to experience an increase in ordinary income equal to the additional interest and penalties until the process is complete, resulting in a greater tax liability.

Mitigating COD Income

There are several ways that COD income may be mitigated. This includes situations in which the taxpayer is insolvent or in Title 11 bankruptcy, the debt is nonrecourse, the taxpayer deeds the title to the mortgagee in lieu of foreclosure, or when the taxpayer sells the personal residence and remits the proceeds to the mortgagee. The debt forgiveness is subject to the Mortgage Forgiveness Debt Relief Act of 2007.

The taxpayer is insolvent or in Title 11 bankruptcy. COD income related to a personal residence is excluded from a taxpayer's income under either a Title 11 bankruptcy or insolvency [IRC section 108(a)(1)(A) and (B)]. Insolvency is defined as the taxpayer having personal debts that exceed the fair market value of the taxpayer's assets, both before and after the discharge of indebtedness. For example, if before a home foreclosure a taxpayer's debts are $300,000 and the value of assets is $250,000, insolvency is $50,000. If the value of the home is $200,000 but the total mortgage debt is $220,000, then after the foreclosure, total debt is $80,000 ($300,000 – $220,000) and the value of assets is $50,000 ($250,000 – $200,000). The taxpayer is still insolvent by $30,000 ($80,000 – $50,000), and no COD income will result.

To the extent the taxpayer is solvent after debt forgiveness, COD income is required. For example, if the taxpayer originally had assets valued at $295,000, $15,000 of COD income is included in gross income [($295,000 – $200,000 value of home) – ($300,000 – $220,000) = $15,000] solvency after the foreclosure. Ordinary income is reported to the extent of this $15,000 solvency.

The debt is nonrecourse. For recourse debt, the selling price is equal to the proceeds to the lending institution upon their disposition of the property. For nonrecourse debt the selling price is the total of the mortgage principal and past-due interest and penalties. [See Treasury Regulations section 1-1001-2(b) and (C) Ex. 7; *Tufts v. Comm'r*, 70 T.C. 756, 763–766.] Because a taxpayer is not personally liable for nonrecourse debt, the taxpayer's wealth increases by the amount of debt relief (including past-due interest and penalties), resulting in an imputed sales price that often exceeds market value. This treatment increases the gain on the sale of a residence (or decreases the loss), but the $500,000 ($250,000 for taxpayers filing singly) exclusion often eliminates any taxable gain. There is no COD gain, because the imputed sales price is equal to the nonrecourse debt.

In a recourse loan situation, the bank may file for personal indemnity, forcing the taxpayer to pay the remaining debt ($28,000 in the earlier COD example). The bank is barred from such action on a nonrecourse loan.

The taxpayer deeds title to the mortgagee in lieu of foreclosure. A taxpayer may initiate contact with the mortgage company, reconvey title to the mortgagee, and vacate the premises. This act saves the mortgagee the time and cost of the foreclosure process. It also stops the accrual of unpaid mortgage interest and related penalties that would otherwise continue to accumulate until foreclosure is completed. This will reduce the amount of COD income when the sale price of the home is less than the debt.

The taxpayer sells the personal residence and remits proceeds to the mortgagee. The taxpayer may sell the residence to a third party at a price below market but in excess of the outstanding debt, including accrued interest and penalties. No COD income exists in this situation. The homeowner may sell at a price less than the outstanding debt, including interest and penalties, but should consider the tax consequences of foreclosure when determining the selling price.

Mortgage Forgiveness Debt Relief Act of 2007

In December 2007, President Bush signed the Mortgage Forgiveness Debt Relief Act of 2007. It will rescue many families facing foreclosure on their personal residences (see H.R.3648 and S.1394, Mortgage Forgiveness Debt Relief Act of 2007). Referring to the House version that passed on October 4, 2007, House Ways and Means Committee Chair Charles B. Rangel (D-N.Y.) said:

> It is just not right or fair that families struggling through a foreclosure would then face a tax bill in addition to losing their homes when they have seen no increase in their net worth. This bill rights that wrong and provides tax relief to millions of American families. [See *Tax Analysts* 2007 TNT 194-1.]
>
> The new law excludes from gross income up to $2 million of COD income by reason of debt reduction of a qualified principal residence indebtedness for foreclosures between January 1, 2007, and December 31, 2009 [new IRC section 108(a)(1)(E)].

Other provisions of the law include:

- Qualified principal residence indebtedness is defined as any indebtedness incurred in acquiring, constructing, or substantially improving the principal residence of a taxpayer if the debt is secured by the residence. In addition, committee reports state that any indebtedness secured by the principal residence resulting from refinancing is allowed if the refinanced debt does not exceed the debt immediately prior to refinancing. For example, qualified principal residence indebtedness refinanced to obtain a lower interest rate is allowed.
- The basis of the individual's principal residence is reduced by the amount excluded from income. This will increase the gain or decrease the loss on the foreclosure sale; however, because a personal loss is disallowed and the first $500,000 ($250,000 for single filers) gain is excluded, there will

likely be no effect on the taxability of the foreclosure.

- The new law does not eliminate all COD income for taxpayers. Home equity loan debt used for any purpose other than to substantially improve the principal residence is not excluded. Debt relief on mortgage debt not related to the home, such as educational, medical, and consumer debt, remains subject to COD income.
- The new law is effective for discharges of indebtedness between January 1, 2007, and December 31, 2009. The sunset provision was included because Congress remains committed to the all-inclusive income concept stated in IRC section 61(a)(12), that cancellation of debt is income because it increases a taxpayer's wealth. Senate Finance Committee Chair Max Baucus (D-Mont.) stated:

From a tax standpoint, a forgiven loan is income. Hopefully we're in a temporary situation here [with the housing crisis], and that's why in my judgment the exemption should be temporary. [See 2007 TNT 96-26, S.1394.]

- The COD exemption applies to a taxpayer's personal residence as defined in IRC section 121. Vacation homes or other real estate investments do not qualify for the exemption.

The COD exemption does not apply if the loan is discharged in exchange for services or if the taxpayer is in Title 11 bankruptcy. The exemption does apply if the taxpayer is insolvent, unless the individual elects to use the insolvency rules.

Considerations for Taxpayers

Taxpayers losing their personal residences from a foreclosure in 2007, 2008, or 2009 may use the new tax rules of IRC section 108 to exclude gain from their COD income. Only mortgage debt forgiveness that was not used for acquisition, construction, or substantial home improvements is taxable income. Because many taxpayers at risk of foreclosure may have used a second mortgage to finance items unrelated to their residence, the benefits of the new law may be limited.

Taxpayers who file a Title 11 bankruptcy, or are insolvent before and after the foreclosure (and elect to use the insolvency rules rather than the new COD tax exclusion), do not have to report COD income. The insolvency rules are preferable over the new rules if the taxpayer has a consumer debt mortgage, which is not excluded from income under new IRC section 108. Rules for determining insolvency are beyond the scope of this article, but should be used if appropriate (see Treasury Regulations section 1-108-6).

Taxpayers who have experienced foreclosure and are required to include COD income under the Mortgage Forgiveness Debt Relief Act of 2007 should consider challenging the reasonableness of the selling price received by the financial institution. For example, a recent article reported a case in which a taxpayer lost his home through foreclosure (Geraldine Fabrikant, "After Foreclosure, a Big Tax Bill from the IRS," *New*

York Times, August 20, 2007), resulting in back taxes of $34,603. The bank, and only bidder, bought the home in a foreclosure sale for $1. It reported COD income (Form 1099C) to the taxpayer for the difference between the mortgage debt and $1. Because $1 was not representative of the fair market value of the home, the taxpayer challenged the 1099C. The lending institution eventually changed the reported COD, eliminating all taxes from the foreclosure.

Taxpayers may refute any COD income reported on a 1099C by both monitoring the subsequent lender sale of the foreclosed property and the resale of the property by the third party who bought it from the lender. This information will support both a corrected Form 1099C and the taxpayer's assertion to the IRS that the 1099 is incorrect. Taxpayers may also document market value by obtaining an independent appraisal before the foreclosure occurs. The appraised value or proceeds from a subsequent sale of the property can be used to support a new fair market value for COD purposes.

Taxpayers are typically eligible for a mortgage interest deduction upon losing the personal residence. This occurs when the sales proceeds are in full or partial satisfaction of the unpaid interest and penalties. The lending institution may not report an interest payment on Form 1098 for the taxpayer, as no actual payment was made. In effect, payment is made to the lender in the form of the sales proceeds the lender receives for the foreclosed property. State laws often require that payments are attributed to interest before principal. In this situation, all unpaid interest is allowed as a mortgage interest deduction. The taxpayer should claim the proper amount of the unpaid interest and penalties.

All COD income must be reported by lending institutions. The burden of proof for exclusion of COD rests with the taxpayer, who must be able to substantiate that loan proceeds were used to substantially improve the principal residence. Prior to the Mortgage Forgiveness Debt Relief Act of 2007, there was no tax reason to retain documentation; therefore, taxpayers may find it difficult to support the expenditures. All taxpayers at risk should retain documentation to support expenditures related to substantial improvement of the principal residence.

Although the foreclosure crisis started in 2006, homeowners who reported COD income on their 2006 returns have almost no chance to argue that the debt was forgiven in 2007 due to a continuing personal liability on the mortgage note after the foreclosure sale. Any COD income reported in 2006 was due to the mortgagee issuing a Form 1099C, stating the amount and date of the mortgage debt cancellation in 2007.

Many foreclosures are expected in the coming years. Recent efforts by the federal government are aimed at reducing that number. For the remainder, the Mortgage Forgiveness Debt Relief Act of 2007 may relieve the burden of a tax liability resulting from foreclosure. The exclusion does not extend to taxpayers who obtained second mortgages for cash unrelated to home improvements, and its documentation requirements may cause a burden; nonetheless, the exclusion is significant—estimated to amount to $600 million in tax savings (*Tax Analysts*,

2007 TNT 244-1).

Tom English, PhD, CPA*, is a professor of accountancy and* ***Bill Lathen*** *is a professor of taxation, both at the college of business and economics at Boise State University, Boise, Idaho.*

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