

## Mortgage Debt Cancellation Relief - H.R. 3648

Public Law No: 110-142    General Information and Provisions

Individuals who are relieved of their obligation to pay some portion of a mortgage debt on a principal residence between January 1, 2007 and December 31, 2012 may not be required to pay income tax on any amount that is forgiven.

### General Provisions of Public Law 110-142:

- No income limitation: All borrowers receive the relief, no matter what their income.
- Dollar limitation: No more than \$2 million of mortgage debt is eligible for the exclusion (\$1 million of debt for a married filing separately return).
- Relief applies only to an individual's principal residence.
- The forgiven mortgage debt must have been secured by that residence.
- No relief is available for cash-outs, whether the cash-out takes the form of a refinanced first mortgage, a second mortgage, home equity line of credit or similar arrangement.
- Eligible debt is what is called "acquisition indebtedness." This is debt used to acquire, construct or rehabilitate a residence.
  - Refinanced debt qualifies, so long as the debt does not exceed the original amount of the debt. (Same rule as Mortgage Interest Deduction)
  - Home equity debt (or second mortgages) qualifies if the funds were used to improve the home. (Borrower must have adequate records, as under current law.)
  - See cash-outs, above. No amount of a cash out may be treated as acquisition debt.

### Additional Provisions of Public Law 110-142:

**Refinanced Mortgages:** The relief does apply to refinanced debt in some circumstances. The rules seek to assure that any debt eligible for the relief is directly related to the acquisition or improvement (such as rehabilitation, expansion, renovation, reconstruction) of the principal residence. Debt used for furnishings (i.e., any movable property) in the home is not eligible for the relief. When the proceeds of any refinanced debt is used for any purpose other than acquisition or improvement, those proceeds are not eligible for the relief.

**Principal Residence:** A principal residence is defined in the same manner as the rules that apply to the capital gains exclusion on the sale of a principal residence. An individual may not have more than one principal residence at any given time.

**Second Homes:** As a general matter, the relief does not apply to any debt forgiveness on any mortgage for any second home of the taxpayer. However, if a taxpayer uses a residence (other than his principal residence) solely as an income-producing rental property, already-existing relief provisions might apply, depending on the taxpayer's situation. If the second home property was acquired as a speculative investment (such as for resale rather than rental), relief provisions are unlikely to be available.

In all events an individual who is in a short sale, foreclosure, workout or similar situation on a residence (including condos) other than his principal residence should consult a tax adviser to determine what, if any, relief provisions might be available.

**Mortgage Insurance Premiums:** The deduction for mortgage insurance premiums is extended through tax year 2010. Income limitations on the deduction will continue to apply.

**Surviving Spouses/\$500,000 Exclusion:** In some circumstances, a surviving spouse is denied eligibility for the full \$500,000 exclusion on the sale of his/her principal residence. This most frequently occurs when the residence is not held in joint ownership at the time the spouse who is not on the title dies. In that case, the deceased spouse had no ownership interest, so there is no basis step-up on that half of the property. The surviving spouse is thus eligible only for an exclusion of \$250,000. (Had the home been sold during the deceased spouse's lifetime, the full \$500,000 exclusion would have applied, so long as they filed a joint return.)

Challenges for the surviving spouse are compounded when this circumstance occurs late in the year. The surviving spouse is often unable to sell the property within the same year that the spouse died. This legislation provides that a surviving spouse may claim the full \$500,000 exclusion not only in the year of the deceased spouse's death, but also during the two years after the spouse's death.

**Second Homes Converted to Principal Residence:** The new law signed by the President does not include a provision limiting the application of the \$250,000/\$500,000 exclusion when a second home is converted to a principal residence and late

### Background Information:

A fundamental principle of the income tax is that a taxpayer must recognize income and pay tax any time a debt of the taxpayer is forgiven or discharged. Exceptions are provided in several circumstances, including bankruptcy, insolvency (as defined by state law) and for some investment real estate. Until this new rule was enacted, however, no exception applied to any amount debt forgiven on a mortgage for a taxpayer's principal residence. Thus, until now, when some portion of a mortgage debt was forgiven, that amount has been treated as taxable income and the borrower has been taxed at ordinary income rates on the forgiven amount, even though there is no cash.

The newly-enacted relief for mortgage debt forgiveness is Congress's response to the problems generated by the subprime crisis, short sales, rising foreclosure rates and price corrections in some markets. Thus, when a lender forgives some portion of a borrower's mortgage debt in a short sale, a foreclosure, a workout with the lender or some similar circumstance, the borrower will not be required to recognize income or pay tax on the forgiven amount. This relief applies to debts forgiven between January 1, 2007 and December 31, 2012.