

Cancellation of Mortgage Debt - Q&A

(June 25, 2012)

General Rule for Debt Forgiveness: If a lender forgives some or all of an individual's debts, the general rule is that the forgiven amount is treated as ordinary income and the borrower must pay tax on the forgiven amount. Exceptions apply for bankruptcy, insolvency and certain other situations, including mortgage debt.

Current Law for Mortgage Debt (January 1, 2007 through Dec 31, 2012): A borrower can be excused from paying tax on forgiven mortgage debt, so long as the debt is secured by a principal residence and the total amount of the outstanding does not exceed the original purchase price plus improvements. Thus, the cancellation of mortgage debt rules will provide relief to a *limited* number of taxpayers.

Example: The provision is best understood with an example.

Assume a family purchased their home for \$175,000, with a mortgage of \$150,000. Later, they need to sell the home. They find that the value of homes in their area has declined and they can sell for only \$120,000. At the time of the sale, the outstanding balance on their mortgage is \$132,000. Thus, there will not be enough cash at settlement to repay the lender the full balance of the mortgage. If the lender forgives the entire difference between the amount owed and the sales price, the debt forgiven will be \$12,000.

Lenders might forgive some portion of mortgage debt in a sale known as a "short sale" (as above, when value at sale is less than amount owed), foreclosure or when there is no sale, but the lender reduces the outstanding balance on a refinanced mortgage.

What happens to the seller when a portion of mortgage debt is forgiven? Under pre-2007 law, the amount of forgiven mortgage debt (the \$12,000 in this example), would have been treated as income, and taxed at ordinary income rates. Thus, the seller, who had experienced a true economic loss, would have been required to pay tax on this phantom income, even though no cash has changed hands and even though he has experienced a loss. Under current law, the forgiven amount is not subject to income tax.

Does this provision apply to a refinanced mortgage? Only in limited circumstances. The relief provision applies to either an original or a refinanced mortgage. If the mortgage has been refinanced at any time, the relief is available only up to the amount of the original debt (plus the cost of any improvements). Thus, if the original mortgage was \$125,000 and later refinanced in a cash-out arrangement for a debt totaling \$140,000, the \$15,000 cash-out is not eligible for relief if a lender later forgives some amount related to the cash-out. Relief is generally not available for second mortgages or home-equity lines of credit where the funds are not used for home improvement.

How does the homeowner get the correct information to the IRS? The lender is required to provide the homeowner and the IRS with a Form 1099 reflecting the amount of the forgiven debt. The borrower/homeowner must determine (often with a tax advisor) whether the forgiven amount is reported (taxable) or excluded (not taxed) from his/her Form 1040 for the tax year in which the debt was forgiven. For example, a lender that forgave mortgage debt in March 2012 would provide the 1099 information to the IRS and the homeowner in January, 2013 and it would be reflected as appropriate on the 2012 Form 1040 that is due April 15, 2013.

Does this provision apply to commercial real estate? Permanent rules enacted in 1993 provide relief to debt-burdened commercial real estate and rental properties. The 2007 provision puts commercial/investment property and residential owner-occupied property on similar footing.

What if a property declines in value, but the owner stays in the house? The provision would not apply. The provision applies only at the time of sale or other disposition or when there is a workout (reduction of existing debt) with the lender. No mechanism exists to reflect the loss of value when a property remains in the hands of the underwater borrower. Similarly, if the home is sold for a loss, there is no capital loss treatment available for that sale.

Do all lenders forgive mortgage debt when property values decline or in foreclosure? No. In states with applicable laws, the lender may require a repayment arrangement, particularly if the borrower has other assets.

When did this legislation pass? A version of the mortgage relief provision passed the House in 1999 and 2000, but was not enacted. The rules of current law were enacted in 2007 as part of H.R. 3648, a bill focused solely on housing issues. The original rules were effective from January 1, 2007 through December 31, 2009. The provision was extended through December 31, 2012 in 2008.

What legislation has been introduced to extend this provision?

In the House, Representative Charlie Rangel (D-NY) has introduced H.R. 4202 to extend the provision for two years. Rep. Tom Reed (R-NY) has introduced H.R. 4336 to extend the provision for one year.

Senator Debbie Stabenow (D-MI) introduced S. 2250 which would extend relief for 2 years.

What is the revenue effect? The President's 2012 Budget estimated a 2 year extension would cost \$2.8 billion over 10 years.