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Mortgage Forgiveness Debt Relief Act of 2007

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Introduction

On December 20, 2007, President Bush signed the Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) into law. The Act increases the incentives for borrowers and lenders to work together to refinance loans, and allows American homeowners struggling to make their regular mortgage payments to secure lower payments without facing higher taxes. Provisions of the Act are summarized here.

Discharge of indebtedness on principal residence

The IRS treats all debt amounts that are reduced, forgiven, or eliminated as part of a mortgage restructuring or foreclosure as taxable income. The Act allows taxpayers to exclude this amount and escape the tax liability. Specifically, the Act provides an exclusion for discharges of up to \$2 million (\$1 million if married filing separately) of indebtedness that is secured by a principal residence. Qualified principal residence indebtedness is debt incurred in acquiring, constructing, or substantially improving the residence. (Cash out refinancing does not qualify for this exclusion.) This tax break applies to debts discharged from January 1, 2007 to December 31, 2009.

For purposes of calculating capital gains, any discharged debts that are excluded from income under the Act must be subtracted from the basis of the taxpayer's principal residence (but not below zero). However, taxpayers may generally exclude from capital gains income up to \$250,000 (or \$500,000 for married couples filing jointly) for properties owned and used as their principal residence for at least two of the last five years.

If only a portion of the loan discharged is qualified indebtedness, the exclusion applies only to the amount of debt discharged that exceeds the amount of the loan that is not qualified indebtedness.

Example(s): Assume that a taxpayer has a \$400,000 loan outstanding on his principal residence, of which \$70,000 is nonqualified debt. If \$100,000 of the loan amount is discharged, only \$30,000 (\$100,000 discharged debt — \$70,000 nonqualified debt) of the debt discharge qualifies for the exclusion.

This provision does not apply to a discharge of indebtedness on account of services performed for the lender. Also, an insolvent taxpayer must use the principal residence exclusion instead of the insolvency exception, unless the taxpayer makes an election to apply the insolvency exception instead of the exclusion provision.

Technical Note: The definition of a taxpayer's principal residence is the same as that under Internal Revenue Code Section 121. Generally, a principal residence is where the taxpayer lives most of the time. Thus, the new law does not apply to vacation homes, second homes, business property, or investment property.

Mortgage insurance deduction

The Act extends the deduction for qualified mortgage insurance premiums that was available in 2007 for three more years; 2008, 2009, and 2010. The deduction is allowable only for mortgage insurance on loans that were originated after December 31, 2006 and before January 1, 2011, unless Congress extends this tax break in the future.

The full deduction is available only to taxpayers whose AGI is less than \$100,000. The deduction is phased out at 10 percent for each \$1,000 by which the taxpayer's AGI exceeds \$100,000.

Technical Note: Qualified mortgage insurance is insurance that is provided by the VA, FHA, the Rural Housing Administration, and private insurers.

Survivor's home sale exclusion

The Act extends the period of time during which a surviving spouse may use the joint- return filers' \$500,000 home sale gain exclusion before being treated as a single individual entitled only to a \$250,000 exclusion. Previously, a surviving spouse was entitled to the \$500,000 exclusion only to the extent he or she could file a joint return with the deceased spouse's estate, which occurs only for the tax year in which the spouse dies. Starting January 1, 2008, the sale of a residence that had been jointly owned and occupied by the surviving and deceased spouse is entitled to the \$500,000 gain exclusion provided the sale occurs no later than two years after the date of death of the individual's spouse.

Tip: The surviving spouse continues to be allowed a step up in basis in the residence for the deceased spouse's one-half share.

Volunteer emergency responders

The Act also gives volunteer firefighters and emergency medical responders some tax relief. Individuals who receive a qualified state and local tax benefit, any reduction or rebate of a tax and qualified payments of up to \$360 each year provided on account of their volunteer services, can exclude them from income. This treatment applies to tax years beginning after December 31, 2007 and before January 1, 2011.

Eligible volunteers must provide services to a "qualified volunteer emergency response organization" which means any volunteer organization that is:

- organized and operated to provide firefighting or emergency medical services for persons in the state or political subdivision, and
- required (by written agreement) by the state or political subdivision to furnish firefighting or emergency medical services in such state or political subdivision

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