

Relief from 'phantom income' coming to stressed sellers

On Dec. 20, President Bush signed into law HR3648, the Mortgage Forgiveness Debt Relief Act of 2007. While this piece of legislation is far from being a cure for all the ills caused by the recent and ongoing meltdown in the real estate-mortgage sector, it will certainly provide relief for some who are caught between declining home values and rising mortgage payments.



It has been widely noted lately that, in certain circumstances, parties undergoing foreclosure or short sales may also face tax bills on the "phantom income" generated by debt forgiveness. Here is a brief example: Suppose you had refinanced your home for \$550,000 and that, now, when you have to sell, its value is only \$500,000. Your lender might agree to a short sale and discharge your mortgage debt, even though the payoff was \$50,000 short.

The catch for you is that you might receive a 1099 from the lender, and be taxed on the \$50,000 of debt forgiveness. You see why it is called "phantom income." (There are, in fact, generally good reasons for taxing debt forgiveness, but that is a whole other discussion.)

HR3648 will provide relief from that kind of tax bite in certain specified situations. Retroactive to Jan. 1, 2007 and lasting until December 31, 2012, certain discharges of mortgage indebtedness on a principal residence will be excluded from a taxpayer's gross income. As always, though, certain restrictions apply.

For one thing, the amount of indebtedness is limited to \$2 million. For most of us folks, this will not present a problem.

Of greater relevance is the fact that, to be excluded, the debt discharged must be *acquisition debt*. That is, the mortgage must have been used to purchase the home.

Suppose, for example, that you have lived in your home for 20 years, that you bought it back when it was "only" \$200,000, and that, by now, you have refinanced it up to \$650,000. Suppose, also, that your neighbor purchased his home just last year, and that he took out a \$650,000 mortgage to finance the transaction.

Now, both of you need to sell and your homes have decreased in value to \$600,000. If you both are granted short sales by the lender, you will both have mortgage debt forgiveness of \$50,000.

Under HR3648, his debt forgiveness will not be taxed because it was acquisition debt. Yours, however, will be. Bummer.

HR3648 also will have relevance in situations where there is not a sale, but where the borrower and lender have restructured the loan and, along with other possibilities such as interest-rate and/or payment reductions, the loan balance has been reduced.

In such cases, the debt forgiveness will not be taxed as ordinary income, but the amount of debt forgiveness will be applied to a reduction in borrower's cost basis in the property. This way, it may subsequently be at least partially recaptured by the Internal Revenue Service in the form of capital-gains tax.

Finally, we note that this tax exclusion only applies in situations where the debt forgiveness resulted from a situation related to a decline in the value of the property or to the financial condition of the borrower.

You wouldn't benefit from it if your mortgage was reduced as a form of payment for services rendered to the lender (suppose you were the bank president).

HR3648 won't solve all the problems out there, but it will certainly be of help to some. That is probably a good thing. Realty Reality by Bob Hunt, OC Register