SPECIAL ALERT: MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007 BRINGS TAX CHANGES TO REAL ESTATE

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The Mortgage Forgiveness Debt Relief Act of 2007 [P.L. 110-142; the "Act"], which was signed by the President on December 20, 2007, includes several provisions affecting the taxation of real estate. The Act changes the treatment of debt forgiveness on principal residences, extends the deductibility of mortgage insurance premiums, modifies the test defining a "cooperative," and expands the exclusion of gain from the sale of a principal residence, among other provisions.

DISCHARGES OF INDEBTEDNESS ON PRINCIPAL RESIDENCE EXCLUDED FROM GROSS INCOME

The Mortgage Forgiveness Debt Relief Act of 2007 [P.L. 110-142; the "Act"][1] amends Section 108 of the Internal Revenue Code of 1986 ("I.R.C.") to exclude from a taxpayer's gross income any discharge of debt on a qualified principal residence. Due to the recent problems in the real estate market, specifically the increase in the number of foreclosures or debt modifications from sub prime loans, Congress provided relief to taxpayers who, when facing a substantial economic loss on their homes, may have essentially phantom income from debt relief.

A taxpayer generally has income from the discharge of indebtedness under I.R.C. § 108, with the only exceptions, prior to the Act, being for insolvent debtors, debtors in bankruptcy, certain farm indebtedness, and certain real property business indebtedness.[2] Many taxpayers facing a foreclosure of their home may have debt relief in the amount of the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt (typically the value of the property), while not qualifying for any of the current exceptions to debt relief. Homeowners may also have relief of indebtedness income from a modification of their current loan, including changes to a loan's adjustable interest rate provisions.[3]

> For example, assume that a taxpayer who is not in bankruptcy and is not insolvent owns a principal residence subject to a $200,000 mortgage debt. If the creditor forecloses and the home is sold for $180,000 in satisfaction of the debt, the debtor has $20,000 of income from the discharge of indebtedness which is includable in

[1] P.L. 110-142, § 2
[2] I.R.C. §§ 108(a)(1)(A) – (D).
[3] See Treas. Reg. § 1.1001-3.

gross income. Likewise, if the creditor restructures the loan and reduces the principal amount to $180,000, the debtor has $20,000 includible in gross income.[4]

The Act excludes from the gross income of a taxpayer any discharge of indebtedness income by reason of a discharge, in whole or in part, of "qualified principal residence indebtedness." Qualified principal residence indebtedness means acquisition indebtedness[5] with respect to a taxpayer's principal residence.[6] While acquisition indebtedness cannot exceed $1 million for purposes of deducting interest on a home mortgage,[7] a taxpayer is entitled to relief from cancellation of indebtedness income of up to $2 million of qualified principal residence indebtedness under the new provision.[8] Note, however, that the relief provided by the Act applies to "acquisition" debt as defined in I.R.C. § 163(h)(3)(B), and not to home equity loans (unless those loans are used for substantially improving a principal residence and otherwise fit within the definition of acquisition indebtedness).

If only a portion of the discharged debt is qualified principal residence indebtedness, the exclusion from income applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness.[9] For example, assume a principal residence is secured by indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold in foreclosure for $700,000 and the balance of $300,000 of debt is discharged, the taxpayer may exclude only $100,000 of the amount discharged from income under this provision. The balance of $200,000 of debt discharge would be taxable income to the taxpayer unless another exception under § 108 applied.[10]

This relief from discharge of indebtedness income on qualified principal residence debt is available only for three years, on debt discharged beginning January 1, 2007 and ending

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[4] H.R. Rep. No. 110-356. Note that discharge of indebtedness income in the case of a foreclosure is created only where the debt is recourse to the taxpayer. See Treas. Reg. § 1.1001-2(a)(2). Where the debt on the principal residence is nonrecouse to the taxpayer, a transfer of the property in satisfaction of the debt is treated as a sale of the property for the amount of the debt, resulting in gain if the debt exceeds the basis of the property. See Rev. Rul. 90-16, 1990-1 C.B. 12. A nonrecourse debt that is simply reduced by the lender, however, will result in discharge of indebtedness income for the homeowner. Rev. Rul. 91-31, 1991-1 C.B. 19.

[5] Acquisition indebtedness is defined in I.R.C. § 163(h)(3)(B) as any indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, for purposes of the home mortgage interest deduction of I.R.C. § 163(h), provided the debt is secured by the residence. Acquisition indebtedness will also include debt resulting from the refinancing of the original acquisition indebtedness, up to the amount of the refinanced debt.

[6] Principal residence has the same meaning for this purpose as under I.R.C. § 121. I.R.C. § 108(h)(5). Note that the taxpayer can have only one principal residence. Thus, this exclusion will not apply to vacation or second homes, even though the taxpayer may be able to deduct the mortgage interest on the second home under I.R.C. § 163(h).

[7] I.R.C. § 163(h)(3)(B)(ii).

[8] I.R.C. § 108(h)(2).

[9] I.R.C. § 108(h)(4).

[10] H.R. Rep. No. 110-356. Where the taxpayer qualifies for more than one exclusion under § 108, certain ordering rules apply. See I.RC. § 108(a)2). For example, the qualified principal residence exclusion will not apply if the taxpayer is in bankruptcy. I.R.C. § 108(a)(2)(A).

on December 31, 2009.[11] In addition, the exclusion from income will not apply if the discharge of indebtedness is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.[12]

The taxpayer must reduce the basis of his or her principal residence by the amount of any income that is excluded under this new provision.[13] While this means that the taxpayer will have more gain on the subsequent sale of a principal residence, that gain is likely to be taxed at capital gain rates or excluded under I.R.C. § 121, while the taxpayer has avoided immediate ordinary income from the debt relief.

EXTENSION OF DEDUCTION FOR CERTAIN MORTGAGE INSURANCE PREMIUMS

Under current law, premiums paid for qualified mortgage insurance by a taxpayer in connection with acquisition indebtedness on a qualified residence of the taxpayer is treated as qualified residence interest.[14] This provision was added to the Internal Revenue Code in 2006[15] and applied only to mortgage insurance contracts issued on or after January 1, 2007, and was scheduled to terminate for any amount paid or accrued after December 31, 2007. Congress extended this present-law temporary provision in the Mortgage Forgiveness Debt Relief Act of 2007 [P.L. 110-142; the "Act"], in order to encourage home ownership. While mortgage insurance premiums are not in the nature of interest, the purchase of such insurance is often demanded by lenders in order for home buyers to obtain financing. Congress believed that permitting deductibility of these premiums in connection with home purchases will foster home ownership.[16] Thus, the Act extended the deduction for private mortgage insurance to amounts paid or accrued after December 31, 2007, but only with respect to contracts entered into after December 31, 2006 and for premiums paid prior to January 1, 2011.[17]

Under both the original and the extended provision, the deductibility of these premiums is phrased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, for married taxpayers filing separate returns).[18] Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000 ($55,000 in the case of married taxpayers filing separate returns).

The deduction only applies to premiums for "qualified mortgage insurance," which is defined as mortgage insurance provided by the Veterans Administration, the Federal

[11] I.R.C. § 108(a)(1)(E).
[12] I.R.C. § 108(h)(3).
[13] I.R.C. § 108(h)(1).
[14] I.R.C. § 163(h)(3)(E)(i).
[15] Tax Relief and Health Care Act of 2006, P.L. 109-342.
[16] H.R. Rep. No. 110-356.
[17] I.R.C. § 163(h)(3)(E)(iv)(I).
[18] I.R.C. § 163(h)(3)(E)(ii).

Housing Administration, the Rural Housing Administration, and private mortgage insurance (as defined in section 2 of the Homeowners Protection Act of 1998).[19]

ALTERNATIVE TESTS FOR QUALIFYING AS A COOPERATIVE HOUSING CORPORATION

Under I.R.C. § 216, a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued to the cooperative to the extent those amounts represent the tenant-stockholder's proportionate share of real estate taxes deductible by the cooperative and interest deductible by the cooperative on indebtedness on the cooperative's land and buildings.[20] The purpose of this provision is to give cooperative owners treatment similar to owners of other residential properties. In order to limit this pass-through treatment to buildings that are primarily residential, I.R.C. § 216 strictly defines what can qualify as a cooperative housing corporation. Under the law prior to enactment of the Mortgage Forgiveness Debt Relief Act of 2007 [P.L. 110-142; the "Act"], a cooperative housing corporation was defined as a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock in the corporation, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, except on complete or partial liquidation of the cooperative, and (4) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest are paid or incurred is derived from tenant-stockholders.[21]

Thus, prior to the Act, the cooperative's non-member income could be no more than 20 percent of its total gross income, in order for its stockholders to deduct real estate taxes and interest. This resulted in cooperatives renting space to commercial tenants at below-market rates in order to comply with the income test, or risk losing their cooperative status when rents for street-level commercial space sky-rocketed.[22] To correct this Congress added two additional non-income based alternatives to the 80-percent requirement, which will still exclude buildings that have large commercial components. I.R.C. § 216 now provides that the fourth requirement listed above can be satisfied in one of three ways: (1) the original rule that 80 percent or more of the corporation's gross income for that taxable year is derived from tenant-stockholders; (2) at all times during that taxable year 80 percent or more of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to such residential use; or (3) 90 percent or more of the corporation's expenditures paid or incurred during that taxable year are paid or incurred for the acquisition, construction, management, maintenance, or care of the corporation's property for the benefit of tenant-stockholders.[23]

[19] I.R.C. § 163(h)(4)(E).
[20] I.R.C. § 216(a).
[21] I.R.C. § 216(b)(1).
[22] *See* H.R. Rep. No. 110-356. *See* § 13.06[5], "Solving Eighty/Twenty Problems," in Cooperative Housing Law and Practice (Matthew Bender & Company, Inc.).
[23] I.R.C. § 216(b)(1)(D).

This provision is effective for taxable years after the date of enactment, which was December 20, 2007.

EXPANSION OF GAIN EXCLUSION ON SALE OF PRINCIPAL RESIDENCE BY SURVIVING SPOUSE

The Mortgage Forgiveness Debt Relief Act of 2007 (the "Act")[24] amends the current provision allowing exclusion of gain on the sale of a principal residence. Specifically, I.R.C. § 121 allows certain married taxpayers filing a joint return to exclude up to $500,000 of gain from the sale or exchange of their principal residence.[25] To be eligible for the exclusion, the taxpayers had to have owned and used the residence as their principal residence for at least two years out of the five-year period ending on the date of the sale or exchange. The exclusion is generally $250,000 for unmarried taxpayers. Prior to the amendment, in order for a surviving spouse selling the principal residence after the death of a spouse to take advantage of the $500,000 exclusion, the sale must occur in the year of the deceased spouse's death so that the surviving spouse could file a joint return with the deceased spouse's estate. A sale by an unmarried surviving spouse after the year of death otherwise would be eligible for only the $250,000 exclusion. The Act amended I.R.C. § 121(b)(4) to allow an unmarried individual whose spouse is deceased on the date of sale to exclude $500,000 of gain, rather than $250,000 of gain, if the sale of the principal residence occurs not later than two years after the death of the spouse and the requirements for excluding $500,000 on a joint return were otherwise met. Thus, if a married couple would have qualified for the $500,000 gain exclusion immediately before the death of a spouse, the surviving spouse can still exclude up to $500,000 of gain if the sale of the residence occurs within two years of the death of the deceased spouse. This provision is effective for sales or exchanges after December 31, 2007.

Note that for property acquired from a decedent, the surviving spouse is likely to get a partial or complete step-up to fair market value in the basis of the property acquired upon the surviving spouse's death,[26] thereby eliminating much of the gain prior to the application of I.R.C. § 121. For example, in community property states, the surviving spouse's share of the community property is also treated as property acquired from a decedent spouse if at least one-half of the community property was includible in the deceased spouse's estate.[27] Thus, the surviving spouse receives a complete step-up in both shares of the property and most if not all gain is eliminated if the property is sold shortly after death. Where property is otherwise jointly held by spouses, the surviving spouse takes a fair market value basis in the decedent's half of the property, thus eliminating half the gain in the property at the time of death, even prior to the application of the gain exclusion under I.R.C. § 121.

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[24] P.L. 110-142, Sec. 5

[25] In order to take advantage of the $500,000 of gain exclusion on a joint return, either spouse must meet the two-year ownership requirement but both spouses must meet the two-year use requirement, and neither spouse can have taken advantage of the § 121 gain exclusion within the prior two years. I.R.C. § 121(b)(2).

[26] I.R.C. § 1014.

[27] I.R.C. § 1014(b)(6).

EXCLUSION FOR BENEFITS PROVIDED TO VOLUNTEER FIREFIGHTERS AND EMERGENCY MEDICAL RESPONDERS

Various states provide types of state and local tax relief to persons who volunteer their services as emergency responders. Prior to The Mortgage Forgiveness Debt Relief Act of 2007 (the "Act"),[28] the IRS took the position that reductions or rebates of property taxes by state and local governments for services performed by volunteer emergency response organizations were taxable income as payments for services.[29] Taxing these benefits significantly reduced their value and added administrative burdens.

The Act acts new Internal Revenue Code § 139B, which excludes from gross income any "qualified state and local tax benefit" and "qualified payments" made to any member of a "qualified volunteer emergency response organization." A "qualified state and local tax benefit" is defined as any reduction or rebate of a tax described in I.R.C. § 164(a)(1), (2), or (3) (which includes state and local real property taxes, personal property taxes, and income taxes) provided on account of services performed as a member of a qualified volunteer emergency response organization.[30] In addition, I.R.C. § 139B will exclude "qualified payments" which are defined as any payments (whether reimbursement or not) provided by a state or local government on account of the performance of services as a member of a qualified volunteer emergency response organization.[31] However, qualified payments are limited for any taxable year to $30 multiplied by the number of months during such year that the taxpayer performs such services.[32] For these purposes, a qualified volunteer emergency response organization means any volunteer organization which is organized and operated to provide firefighting or emergency medical services for persons in the state or local political subdivision, and which is required by written agreement with the state or local government to furnish such services.[33]

Taxpayers excluding amounts under this provision can not deduct such amounts under I.R.C. § 164 (deduction for state and local taxes) nor under I.R.C. § 170 (deduction for charitable contributions).[34] This provision is effective for taxable years beginning after December 31, 2007 and terminates with respect to taxable years beginning after December 31, 2010.

CLARIFICATION OF STUDENT HOUSING ELIGIBLE FOR LOW-INCOME HOUSING CREDIT

The low-income housing credit of I.R.C. § 42 applies only to qualified low-income buildings. Units will not fail to qualify as low-income units merely because they are occupied by full-time students, provided that the students are (i) married and file a joint

[28] P.L. 110-142, Sec. 8
[29] CCA 200302045.
[30] IRC § 139B(c)(1).
[31] IRC § 139B(c)(2)(A). Note that the payment must come from the state or local government, and not from the volunteer organization.
[32] IRC § 139B(c)(2)(B)
[33] IRC § 139B(c)(3).
[34] IRC § 139B(b).

return, or (ii) are single parents and their children, as further defined under IRC § 42.[35] The Mortgage Forgiveness Debt Relief Act of 2007 (the "Act")[36] amended the test for single parents and their children to clarify unclear drafting. Prior to the Act, the "single parents and their children" test was described as single parents and their children provided those individuals were not dependents of another individual. The revised language clarifies that the single parent cannot be a dependent of another individual, and the child of that parent cannot be a dependent of another individual other than a parent of that child.

This provision is effective for housing credit amounts allocated before, on, or after the date of enactment (December 20, 2007), and for buildings financed with certain tax-exempt obligations which are not subject to the credit allocation rules of I.R.C. § 42(h)(1), it is effective for buildings placed in service on, before, or after the date of enactment.[37]

[35] I.R.C. § 42(i)(3)(D)(ii).
[36] P.L. 110-142, Sec. 6.
[37] P.L. 110-142, Sec. 6(b).