

TAX IMPLICATIONS OF THE SHORT SALE AND FORECLOSURE ENVIRONMENT

Addressing the subprime lending crisis, Congress recently passed and the President signed into law a new measure giving tax breaks to homeowners who have mortgage debt relieved or forgiven. Under old law, the debt forgiven by a lender, such as for short sales or loan restructuring, was generally taxable to the borrower as debt discharge income. With the passage of the Mortgage Forgiveness Debt Relief Act of 2007, a taxpayer does not have to pay federal income tax on up to \$2 million of debt forgiven for a loan secured by a qualified principal residence. The exclusion applies where taxpayers restructure their acquisition debt on a principal residence or lose their residence in a foreclosure proceeding. The discharge of indebtedness must also be directly related to a decline in the value of the residence or to the taxpayer's financial condition. The change in the tax law applies to debts discharged beginning January 1, 2007 through December 31, 2009.

Here is some of the critical fine print in this new relief provision:

- The indebtedness must be incurred with respect to the taxpayer's principal residence only. The exclusion rule does not apply to second homes, vacation homes, business property, or investment property.
- Tax relief applies to the original purchase price, plus improvements, of taxpayer's principal residence. It does not apply to discharges of second mortgages or home equity loans, unless the loan proceeds were used to acquire, construct, or substantially improve the residence. Refinanced debt qualifies to the extent it does not exceed the amount of debt being refinanced. (In other words, cash out from refinancing does not qualify for the exclusion.)
- The relief provision is not permanent; it applies to mortgage debt discharge during 2007, 2008, or 2009.
- Nontaxable forgiven mortgage debt is capped at \$2 million (\$1 million for married individuals filing separately.)
- When the relief provision applies, the cost basis of the individual's principal residence is reduced by the amount excluded from income (but not below zero). As a result of this basis reduction rule, the discharged debt is subject to tax at a later time, when the principal residence is sold. However, in many cases, the reduction will not result in any additional tax, because any gain on such sale will qualify for the \$250,000 (\$500,000 for married couples filing jointly) home-sale exclusion.

One important point to note is that this is a federal relief provision only, and California has not conformed to it. Therefore, for California income tax purposes, old law is still the governing principle; that is, forgiveness of debt is treated as giving rise to income includible in gross income. Exceptions to the general rule include: 1) the discharge occurs in a Title 11 bankruptcy case, 2) insolvency of the taxpayer, 3) discharge of qualified farm indebtedness, or 4) discharge of qualified real property indebtedness.

Please keep in mind that this is only a summary of this important tax relief provision. If you would like more details about this change, or any other aspect of the new law, please do not hesitate to call.

NOTE: This newsletter represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation. This information is not a substitute for a personal consultation with a CPA.

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