MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007 (HR 3648)

Cancellation of Acquisition Indebtedness on Principal Residences Excluded From Gross Income

The sub-prime mortgage crisis is expected to cause 2.5 million home foreclosures in the next few years. A taxpayer subject to foreclosure might end up homeless and still face a nasty tax bill from Uncle Sam for cancellation of debt income. To address this looming tax dilemma, Congress retroactively added a new §108 exclusion to cancellation of debt income.

Effective for discharges of indebtedness on or after January 1, 2007 and before December 31, 2009, the Mortgage Forgiveness Debt Relief Act of 2007 excludes from a taxpayer's gross income any discharge (in whole or in part) of qualified principal residence indebtedness (new §108(a)(1)(E)).

Qualified Principal Residence Indebtedness

Qualified principal residence indebtedness means acquisition indebtedness [within the meaning of §163(h)(3)(B) except that the dollar limit is $2 million ($1 million in the case of a separate return) with respect to the taxpayer's principal residence.] Qualified principal residence indebtedness does not include home equity indebtedness.

Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the refinancing does not exceed the amount of the refinanced indebtedness.

> **Note**: For these purposes the term "principal residence" has the same meaning as under §121. It does not include the taxpayer's vacation home, rental or investment property.

When a portion of the mortgage is acquisition indebtedness. If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness.

> **Example.** Assume Sharon's principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 of the debt is discharged, then only $100,000 of the amount discharged may be excluded from Sharon's gross income under this provision.

> **Warning**: Homeowners who refinanced their principal residence mortgage to pay off personal credit card debts, car loans or for other personal uses are not entitled to this new exclusion and will have cancellation of debt income.

Basis Reduction

The basis of the individual's principal residence is reduced by the amount excluded from income.

Bankrupt or Insolvent Taxpayers

The exclusion does not apply to a taxpayer in a Title 11 bankruptcy case; instead the present-law exclusion at §108(a)(1)(A) applies. In the case of an insolvent taxpayer not in bankruptcy, the exclusion under the bill applies unless the taxpayer elects to have the present-law exclusion at §108(a)(1)(B) apply.

Discharge of Indebtedness in Exchange for Services Rendered

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender.

Checklist for Exclusion of Cancellation of Home Mortgage Indebtedness	
Must be principal residence as defined under §121	
Must be acquisition indebtedness as defined in §163 √original or refinanced debt √secured by the principal residence √recourse debt [1] √under $2 million of acquisition debt √not borrowing used for personal purposes	
Homeowner has not filed bankruptcy	
If homeowner is insolvent, may elect to use this provision	
Cancellation is not for personal services rendered	

> **Preparer Point**: Use form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, to report the exclusion and the basis reduction.

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[1] Non recourse loans forgiven in foreclosure are treated as the sales price of the property. Thus no cancellation of debt income occurs. The new law is to protect homeowners with recourse financing from cancellation of debt income.