



## LEGISLATIVE UPDATE

# MORTGAGE FORGIVENESS ACT OF 2007 AND SHORT SALES -- A PRIMER

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**M**ortgage foreclosure can be one of the most devastating things a homeowner can face. At a minimum, he or she will likely end up with damaged credit.

### The "Double Whammy"

**U**ntil recently, the tax laws further penalized homeowners who were relieved of mortgage debt obligations with additional taxation. Homeowners owe taxes on the amount of the debt obligation from which they are relieved. For example, in a "short sale" situation, if a bank agreed to accept \$200,000 as payment in full to satisfy a mortgage where the homeowner owed \$250,000, the homeowner would owe taxes on the \$50,000 amount "forgiven". The \$50,000 of the mortgage debt forgiven relieved the homeowner of the obligation to repay it. When a homeowner is relieved of debt, a financial benefit results because he or she no longer has the obligation to pay it back. Hence an income tax obligation arises with this "unrealized income" even if there was no direct corresponding benefit, such as equity proceeds from a sale. As a practical matter,

how is the homeowner who just lost everything going to be able to pay tax on the differential of the satisfied mortgage obligation when he or she received no tangible proceeds from the sale?

While it has received some media coverage, it is still not commonly known that forgiveness of any portion of debt in a home foreclosure or "short sale" situation can result in reportable taxable income. Many people who've walked away from their homes have found this out the hard way. Many found out at the end of the year when they opened their mail and found they'd received a 1099C. (The 1099C is the IRS form that a creditor issues to report that it has forgiven a portion of a debtor's debt.)

### Mortgage Forgiveness Debt Relief Act of 2007

**O**n December 20, 2007, President Bush signed the **Mortgage Forgiveness Debt Relief Act of 2007** (H.R. 3648; P.L. 110-142). This new law will protect some but not all foreclosed homeowners from a "double whammy" where a 1099C

form is sent by the lender after a portion of the debt is forgiven.

Now, debt forgiveness in connection with a foreclosure proceeding against a personal residence will not be treated as taxable income if the debt forgiveness occurs within a specified two-year period. The protection is subject to certain provisions and limitations:

1. The relief applies to debts forgiven between January 1, 2007, and December 31, 2009.
2. There is no income limitation.
3. Mortgages must have been secured by the borrower's principal residence. A borrower cannot have more than one principal residence. Debt must be deemed "acquisition indebtedness;" debt must have been used to buy build, or rehab the primary residence.
4. Limited to \$2,000,000 of mortgage debt (\$1,000,000 for married persons filing separate returns)
5. Does not apply to cash-outs.

6. Home equity debt may qualify if the money owed was used to make home improvements.
7. Refinanced debt qualifies if it is not more than the amount of the original debt.

### Some Fine Print

Note that since the forgiveness is limited to debt incurred in buying or improving the house, it will not help those who took out a second mortgage or home equity line of credit to consolidate high interest credit card debt at a time when home values were skyrocketing and sub-prime lenders were handing out money like candy. Generally, those who refinanced their homes would not have done so without paying off outstanding consumer debt. In many cases, it would have been a lender requirement. This portion of the home debt will continue to trigger tax liability when the loan is foreclosed.

Under the circumstances, homeowners should do a careful analysis of their loan history and actual expenditures made. Without such an analysis, an unfortunate byproduct of this legislation could well be a false sense of security for a homeowner facing foreclosure. The failure to act promptly could result in some unpleasant surprises at tax time.

Also, second homes, vacation homes, business and investment property are not included in the forgiveness; it will only apply to debt secured against the qualified principal residence of the

taxpayer. If a taxpayer has two homes, only the home that is used the majority of the time will qualify in most circumstances.

### The Bottom Line

The Mortgage Forgiveness Debt Relief Act of 2007 provides an incentive to protect a homeowner's credit and work out an acceptable solution with a lender such as a short sale. Potential income tax liability now can often be eliminated as an impediment to a short sale since the law removes tax liability that otherwise would result from mortgage forgiveness. A short sale in such instances will be beneficial to the seller's credit and may be helpful when the seller becomes a buyer and wants to obtain another mortgage in the future. Homeowners and lenders now have more incentive to work together to either sell or refinance the existing mortgage debt, without having to pay tax on the amount forgiven.

In general, short sales impact market values less than a lender going through the foreclosure process and then reselling the property as an REO, and should be encouraged where feasible since the large numbers of foreclosures the country is currently experiencing will otherwise cause lasting harm to real estate market valuations and to communities.

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