The Mortgage Forgiveness Debt Relief Act of 2007: Two New Provisions Regarding Principal Residence

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Introduction

In December of 2007, in response to the collapse of the housing market and the rapid increase in foreclosures, Congress enacted the Mortgage Forgiveness Debt Relief Act of 2007 (the “Act”). See Mortgage Forgiveness Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803. Under the Act, Congress introduced several new provisions to the Internal Revenue Code (the “Code”), including two regarding an individual’s principal residence. Mortgage Forgiveness Act of 2007 §§ 2 & 7 (codified in I.R.C. §§ 108(a)(1)(E), 108(h), 121(b)(4)). The first—and the more highly publicized of the two—excludes the discharge of debt related to the acquisition and/or improvement of one’s principal residence from ordinary income. See I.R.C. § 108(a)(1)(E), (h). The second modifies the exclusion of gain from the sale of the former marital principal residence by the surviving spouse. I.R.C. § 121(b)(4). This article provides an overview of the relevant laws regarding the discharge of indebtedness income and the exclusion of gain from the sale or exchange of a principal residence, with a focus on the changes to the law under the Act.

The qualified principal residence exclusion

For federal income tax purposes, when an individual borrows money, the borrowed funds do not constitute income to the individual. Although the borrower now has more money in his pocket, he also has an offsetting obligation to repay the debt. Therefore, the borrower does not have an accession to wealth. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 427-33 (1955). However, if the borrower is no longer required to satisfy such debt, then he has income, unless an exclusion exists. See I.R.C. § 61(a)(12).

There are several statutory exclusions for not including the discharge in ordinary income, including that the borrower is insolvent or the discharge occurs as part of a bankruptcy proceeding, I.R.C. § 108(a). Consequently, prior to the Act, when a lender foreclosed a mortgage and waived its right to seek any deficiency or if the value of the home declined and the lender forgave a portion of the borrower’s mortgage, such amount of debt forgiveness constituted income to the borrower. I.R.C. § 61(a)(12). Thus, not only did an unfortunate person have to cope with the heartache of losing his home, but he also incurred a tax liability. This result was exacerbated by the fact that, for tax purposes, an individual cannot deduct the loss on the sale of a personal residence. I.R.C. § 165(a), (c). For example, in January of 2003, when the housing market was booming, Jackson purchased a home for $200,000 with an interest-only three-year adjustable rate mortgage from Bank X. In January of 2006, Jackson’s payment substantially increased, as the interest rate increased, and he could no longer make his monthly payments. Accordingly, Bank X filed a foreclosure action against Jackson. Because of the decline in the housing market, the bank recovered only $175,000 at the foreclosure sale on Jackson’s home. As a result, the pro-
ceeds from the foreclosure sale were inadequate to cover the balance on Jackson's note. Given Jackson's financial condition, Bank X forgave the remaining balance secured by the mortgage. In this example, Jackson had a loss on the sale of his house of $25,000. Concurrently, Jackson had ordinary income of $25,000, as the Bank forgave that amount and thus made him $25,000 wealthier. It would make sense that for tax purposes, Jackson should have been able to offset his $25,000 loss and $25,000 of income. However, he could not deduct the loss and instead had $25,000 of discharge of indebtedness income.

Many people viewed this result as unfair, thus giving rise to the Act, which created "a three-year window for homeowners to refinance their mortgage and pay no taxes on any debt forgiveness they receive." Statement by President George W. Bush Upon Signing [H.R. 3648], 2007 U.S.C.C.A.N. S31, S32 (available at 2007 WL 4984167 (Dec. 20, 2007)). One of the main goals of the new provision was to "help hard-working Americans take steps to avoid foreclosure during a period of uncertainty in the housing market" by encouraging the modification of mortgages, including the forgiveness of part of the debt, without incurring a tax. Id. at S31.

Thus, pursuant to the Act, Congress added sections 108(a)(1)(E) and (h), which provide that the cancellation of "Qualified Principal Residence Indebtedness" (QPRI) is not income. QPRI is debt not exceeding $2 million (or $1 million if married filing separately) related to acquiring, constructing or substantially improving an individual's principal residence. I.R.C. § 108(h)(2). QPRI also includes the refinancing of mortgages in amounts not exceeding the old mortgage principal immediately before the refinancing. Id. For an amount exceeding the old mortgage principal to be considered QPRI, the proceeds must be used to substantially improve the principal residence. See I.R.C. § 1016.

The new exclusion is a temporary provision, as it applies only to QPRI discharged in 2007, 2008 or 2009. I.R.C. § 108(a)(1)(E). The new provision also does not apply to investment properties and vacation homes. I.R.C. § 108(h)(5).

Additionally, a foreclosure action is not required for the exclusion to apply. I.R.C. § 108(h)(3). Rather, the only requirement is that the discharge of QPRI be "directly related to the decline in the value of the residence or to the financial condition of the taxpayer" as opposed to being related to "services performed for the lender." Id.

If a debt secured by a mortgage is discharged and the entire mortgage is not QPRI, then the exclusion applies only to the amount of discharge that exceeds the non-QPRI amount immediately before the discharge. I.R.C. § 108(h)(4). For example, assume Jace purchased his home for $200,000, and it was secured by an interest-only adjustable rate mortgage of $180,000. Later, Jace refinanced the entire value of his home, obtaining a new interest-only adjustable rate mortgage of $200,000. Subsequently, Jace used $20,000 of the money to attend law school. As a result of Jace using the $20,000 he received from refinancing his home for something other than improving his principal residence, the $20,000 is not QPRI. If the lender forecloses on the property when it is valued at $150,000 and discharges the remaining $50,000 of debt, only $30,000 can be excluded under the new provision. Of the $50,000 debt that was discharged, $20,000 relates to nonqualified debt (i.e., the proceeds used to pay for Jace's law school education) and is not excludable from income under the Act. This $20,000, however, might qualify in whole or in part for one of the other exclusions under section 108.

But as the saying goes—"there is no such thing as a free lunch"—and in this situation it holds true. If an individual takes advantage of this exclusion, he must then reduce (but not below zero) his basis in the principal residence by the amount of QPRI discharged by the lender and excluded from income. I.R.C. § 108(h)(1). The basis reduction provision will mainly arise in situations where the lender opts not to foreclose on the mortgage, but instead executes a loan modification agreement forgiving a portion of the loan. Thus, the borrower's basis in his principal residence must be reduced by the amount of the QPRI excluded from income. Upon the future sale of the borrower's principal residence, the decrease in basis could potentially cause the borrower to have taxable income. However, this may not be an issue for most homeowners, as the Code already provides an exclusion of up to $500,000 of gain on the sale or exchange of an individual's principal residence. See I.R.C. § 121 (discussed later in this article).

Some scholars have argued the basis adjustment provision could also affect the income calculation on a foreclosure sale of property secured by a recourse debt. This is true only if the basis adjustment was to be made immediately before the discharge. However, the new provision is silent on when the basis adjustment should be made. Nevertheless, it is more likely the basis adjustment is to be made at the beginning of the tax year preceding the discharge of indebtedness, as all other adjustments to basis under section 108 are to be made at such time. See I.R.C. §§ 108(b)(4)(A), 1017(a)(2). Thus, the only time the basis provision should have any effect is if the borrower retains his principal residence.

Returning to Jackson's example from above, if Jackson's mortgage were forgiven after December 31, 2006, but before January 1, 2010, then he would not have to report the $25,000 of income, as it would be excluded under the new exclusion provision of the Act. Additionally, in terms of filing practicality, it is not within the lender's discretion to determine whether this exclusion applies. Instead, the lender should file Form 1099-C, Cancellation of Debt, reporting the amount of the discharged debt if it is more than $600. Then, it is the borrower's decision to determine whether the QPRI exclusion applies. If the borrower determines the exclusion applies, he must file a
Gain exclusion on the sale of the former marital residence by the surviving spouse

When an individual sells his personal residence, any gain on the sale is gross income unless an exclusion exists. I.R.C. §§ 61(a)(3), 1001(c). Under section 121, gain realized on the sale of an individual’s principal residence is excludable if during the five years preceding the sale or exchange, (1) the property was owned and used by the individual for periods aggregating two years or more (“ownership and use requirements”) and (2) the individual has not used this exclusion on a sale within the last two years (“frequency requirement”). I.R.C. § 121(a)-(b). In regards to the ownership requirement, for a husband and wife to qualify for the exclusion, it is not required that both own the property. I.R.C. § 121(b)(2)(A)(i). Assuming an individual can satisfy these requirements, he may exclude up to $250,000 (or $500,000 if filing a joint return and the spouse also meets these requirements). I.R.C. § 121(b). An individual failing to meet these requirements is eligible to receive a reduced exclusion if the reason for the sale of the principal residence is by reason of change in place of employment, health or other unforeseen circumstances. I.R.C. § 121(c).

Prior to the Act, gross disparities existed in the application of the general gain exclusion of section 121. Specifically, the exclusion provided a financial incentive to surviving spouses who were able to sell the former marital home in the year of their spouse’s death. Treas. Reg. § 1.121-2(a)(4), Ex. 5. If the death of the spouse occurred towards the end of the taxable year, such incentive usually was not available to the surviving spouse, as selling the former marital home before the end of the year might not have been feasible.

To understand this arbitrary and unfair result, it is best to examine a few examples. For purposes of simplifying the examples (i.e., by avoiding any discussion of the estate tax rules), the title to the home is only in the husband’s name.

**Example 1.** In 1980, Husband and Wife bought a home for $90,000. On June 24, 2006, Husband and Wife sold it for $1 million. The gain on the sale is $910,000. The gain would be taxable to Husband and Wife unless the gain exclusion applies. Because Husband and Wife meet the ownership, use and frequency requirements and file a joint return, they can exclude $500,000 of the gain. The remaining $410,000 is taxable income.

**Example 2.** In 1980, Husband and Wife bought a home for $90,000. On January 1, 2006, Wife passed away. On June 24, 2006, Husband sold the former marital home for $1 million. The gain on the sale is $910,000. Because Husband meets the ownership, use and frequency requirements, he is entitled to exclude $250,000.
However, since the home was sold in the year of Wife’s death, Husband can elect to file a joint return. I.R.C. § 6013. Accordingly, Husband can use Wife’s $250,000 exclusion, aggregate the two and exclude $500,000 of the gain, yielding the same results as in Example 1.

**Example 3.** In 1980, Husband and Wife bought a home for $90,000. On December 31, 2006, Wife passed away. On January 1, 2007, Husband sold the former marital home for $1 million. The gain on the sale is $910,000. Because Husband meets the ownership, use and frequency requirements, he is entitled to exclude $250,000.

However, because the home was sold after the year of Wife’s death, Husband cannot elect to file a joint return. *Id.* Accordingly, Husband can only use his $250,000 exclusion. Thus, unlike Examples 1 and 2, Husband is subject to tax on $660,000 instead of on $410,000. At the current capital gain tax rates, this is an additional $37,500 in taxes.

As the examples demonstrate, in the situations where a spouse dies in the early part of the year, it is potentially more feasible for the surviving spouse to sell the marital home within the same year of death. Thus, the surviving spouse can benefit from filing a joint return resulting in a tax savings of up to $37,500. Nevertheless, such a sale is contrary to grievance counselors’ advice that a surviving spouse should not make any major decisions within the first year of a spouse’s death.

Under the Act, Congress recognized this arbitrary and unfair result and created a provision with the intent of avoiding this result. The new provision provides:

In the case of a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale, [the amount of gain excluded from gross income with respect to any sale or exchange shall not exceed $500,000] if such sale occurs not later than 2 years after the date of death of such spouse and the [ownership, use, and frequency] requirements ... were met [by both spouses] immediately before such date of death.

I.R.C. § 121(b)(4). This new provision is effective for sales and exchanges beginning in 2008. Mortgage Forgiveness Debt Relief Act of 2007, § 7(b). Thus, if the sale in Example 3 occurred after December 31, 2007, but before two years from the date of death (i.e., December 31, 2008), the new provision would apply and the result would be the same as in Examples 1 and 2.

But, beware—the provision requires the surviving spouse be “an unmarried individual” and does not indicate whether the requirement is temporally connected to the time of the sale or the period of time between the date of his spouse’s death and the sale of the marital home. I.R.C. § 121(b)(4). Though there is no express guidance, it is more than likely the proper interpretation is that the surviving spouse cannot have remarried between the date of his spouse’s death and the sale of the marital home. This is because the same language requiring “an unmarried individual” is used in another paragraph of section 121, and according to the regulations thereunder, “an unmarried individual” means that “[t]he taxpayer has not remarried at the time of the sale or exchange of the [former marital] property.” I.R.C. § 121(d)(2); Treas. Reg. § 1.121-4(a).

Assuming both spouses meet the ownership, use and frequency requirements immediately before the deceased spouse’s death, the new provision eliminates both the arbitrary results and the tax need for the surviving spouse to make a decision regarding the sale of the former marital home. Nevertheless, the new provision fails to consider that one spouse or both may not meet the ownership, use and/or frequency requirements. In this situation, the surviving spouse would be burdened with the decision to sell the former marital home in the year of the deceased spouse’s death, which may not even be feasible, to take advantage of the deceased spouse’s reduced exclusion under section 121(c). This
is because if one or both spouses do not meet the ownership, use and/or frequency requirements, they would look to section 121(c) to obtain a reduced exclusion. However, the new provision does not apply to obtaining a reduced exclusion, as it expressly only applies to the general exclusion set out under sections 121(a)-(b). Thus, the only way for a surviving spouse to take advantage of the reduced exclusion of the deceased spouse is still to sell the former marital home in the year of death and elect to file a joint return. For example, on January 1, 2007, Husband and Wife purchased a home for $100,000. On June 24, 2008, Wife passed away. Immediately before Wife's death, Husband and Wife did not meet the ownership and use requirements, as Husband and Wife did not own and use the house for the required two-year period. Thus, Husband is not eligible for the benefits of the new provision. Instead, Husband is forced to sell the home in the year of Wife's death if Husband desires to take advantage of Wife's reduced exclusion.

Moreover, other issues remain regarding the interplay between the new provision and the tacking provision of section 121(d)(2). Under section 121(d)(2), a surviving spouse is treated as owning and using the former marital home as the surviving spouse's principal residence during any period the deceased spouse owned and used the former marital home before death, if the surviving spouse has not remarried and the surviving spouse's spouse was deceased at the time of the sale. See Treas. Reg. § 1.121-4(a). For example, in 1980, Wife purchased a home. On June 24, 2006, Husband married and transferred one-half of the home to him. On October 31, 2006, Wife passed away. If husband sold the home on June 24, 2007, Husband does not meet the ownership or use requirement, as he only owned and used the house for one year. However, under the tacking rules, Husband is treated as owning and using the former marital home for the period Wife owned and used the home. Therefore, Husband is deemed to have owned and used the house since 1980. As a result, Husband meets the ownership, use and frequency requirements.

However, it is unclear whether the tacking provision can be applied in determining if the requirements of the new provision are met. For the new provision to apply, the ownership and use requirements must be met immediately before the date of the deceased spouse's death (the "Test Date"). I.R.C. § 121(b)(4). Accordingly, on the Test Date, neither spouse is unmarried or deceased. Therefore, it is unclear if the tacking provision will apply, as the tacking provision requires that there be "an unmarried individual" and a "deceased spouse." So, the question becomes—in testing to see if the requirements of the new provision are met—can one consider only the facts that exist as of the Test Date or the facts that occurred before and after the Test Date?

For example, in 1980, Wife purchased a home. On June 24, 2006, Wife married Husband. On October 31, 2006, Wife passed away. Immediately before Wife's death, Husband and Wife did not meet the ownership and use requirements, as Husband did not use the home for the two years. The fact that Husband has not owned the former marital residence is irrelevant, as the ownership requirement provides only that one spouse own the house for a two-year period. I.R.C. § 121(b)(2)(a)(i).

Consequently, if the tacking provision cannot be applied in the application of the new provision, the sale of the former marital residence would not fall within the scope of the new provision. This is because Husband and Wife would not meet the ownership, use and frequency requirements immediately before Wife's death. Accordingly, if Husband wanted to benefit from Wife's gain exclusion and tacking provision, he would have to sell the former marital home in the year of Wife's death and elect to file a joint return. Then, Husband would be deemed to meet the use requirement, as he would be allowed to tack on the time Wife used the home to his time using the home, resulting in Husband qualifying for the $500,000 exclusion.

Conversely, if the tacking provision can be applied in the application of the new provision, the sale of the former marital residence would fall within the scope of the new provision. This is because Husband would be allowed to tack on the time Wife used the home to his time using the home. As a result, Husband and Wife would meet the ownership, use and frequency requirements immediately before Wife's death and would fall within the scope of the new provision. This would provide Husband with two years from the date of Wife's death to sell the home and to qualify for the $500,000 exclusion.

Thus, until future guidance is issued, one should be aware of the risk associated with relying on section 121(d)(2) to fall within the scope of the new provision.

**Conclusion**

The Act, while only encompassing six pages, made two sweeping changes to the taxation of principal residences. However, while the Act implemented only changes to the Code, it is important for both tax counsel and non-tax counsel to become familiar with these changes, as they affect other areas of the law. It is also important for counsel to recognize that the provisions are new and, like any new provision, there are still many unanswered questions regarding their application.

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* On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the "Stabilization Act") was signed into law. Pub. L. No. 110-343, 122 Stat. 3765. Under the Stabilization Act, the Qualified Principal Residence Exclusion is extended to sales that occur in 2010 and 2011. Id. at § 303. However, the effective date of the amendment is January 1, 2010. Thus, it is possible that before January 1, 2010, the amendment may be repealed.