

On December 20, 2007, the Mortgage Forgiveness Debt Relief Act of 2007 (the "Act") was signed into law. The Act was passed in part in response to the disruption in the housing market caused by the subprime lending problems and the foreclosures that are likely to occur as a result of such problems.

Prior to the passage of the Act, debt forgiven following foreclosure of a lien against real estate or as a result of a negotiated short sale could be considered to be income for tax purposes. This could result in additional income tax liability for the borrower whose property was foreclosed or whose property was sold for a price lower than the outstanding loan balance. As a result of the Act, in some circumstances, debt forgiven following a foreclosure or short sale will no longer be considered to be income.

The Act applies to "qualified principal residence debt" which is forgiven between January 1, 2007 and January 1, 2010. The amount of forgiven debt which is excluded from being treated as income is limited to \$2,000,000 in a transaction. "Qualified" principal residence debt is debt incurred to acquire, construct or

substantially improve a principal residence. "Principal residence" is a property which a borrower has occupied as the borrower's principal place of residence for at least two of the five years immediately preceding the forgiveness of the debt. The Act only applies to debt forgiveness which relates directly to a decline in the value of a borrower's property or to a decline in the financial condition of a borrower.

An issue will arise if the debt which is being forgiven was incurred in part for purposes other than acquisition, construction or improvement of the property. This could occur in a cash out refinance where the "cash out" portion of the debt would not have been incurred for acquisition or improvement of the property. The issue would also arise in instances where refinancing costs were rolled into refinancing loans, a portion of which were subsequently forgiven.

As an example, if a borrower owes \$200,000 on a refinancing loan which refinanced \$170,000 of purchase money debt, included \$10,000 of "rolled in" closing costs and resulted in the borrower receiving \$20,000 cash out (only possible in Texas with

home equity loans or loans on non-homestead property), \$30,000 of the debt would not qualify under the Act.

If a foreclosure or short sale in this scenario resulted in the forgiveness of \$40,000 of debt, \$30,000 of the forgiven debt would be treated as income and \$10,000 would not. If the foreclosure or short sale resulted in \$20,000 of forgiven debt, all of the forgiven debt would be treated as income.

The Act contained two other provisions of interest to real estate practitioners. Mortgage insurance premiums will be treated as interest until December 31, 2010. This includes private, FHA and VA mortgage insurance premiums. Also, if a surviving spouse sells the family home within two years of being widowed and the other requirements of Section 121 of the Internal Revenue Code are met, the surviving spouse is entitled to exclude \$500,000 of gain from recognized income rather than the \$250,000 a single taxpayer is entitled to exclude on a qualifying sale of a principal residence.



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