House Passes "Phantom Income" Mortgage Relief Bill with Second Home Tax Restrictions

by Kenneth R. Harney

Homeowners facing financial distress got some good news from Congress last Thursday. The House overwhelmingly approved legislation that would end the controversial practice of imposing federal income taxes on borrowers whose mortgage lenders forgive a portion of their debt as part of a "workout" or pre-foreclosure short sale arrangement.

Under current law, the federal tax code essentially punishes homeowners in deep financial distress. When a lender "discharges" -- writes off -- a portion of their principal debt, the IRS demands income taxes on the full amount of debt relief.

For example, if a short sale designed to avoid foreclosure produces $25,000 less than the balance owed to the lender, some lenders choose to forgo that remainder rather than fight the borrower. But the IRS requires the lender to report the $25,000 debt forgiveness on a Form 1099-C. The IRS then treats the $25,000 as ordinary, taxable income.

Not only does that tend to worsen families' financial distress when they are down -- they've lost their home and equity, their credit is shot -- but it complicates some borrowers' willingness to engage in loss-mitigation programs offered by lenders.

The House-passed bill (HR 3648) would prohibit income tax levies on home mortgage debt discharges. Similar legislation is pending in the Senate (S 1394). The House bill is retroactive to Jan. 1, 2007, thereby assisting borrowers who received debt relief any time this year, and in future years. It would not apply, however, to transactions closing in 2006 or earlier.

The House bill also extends another key tax benefit-the deductibility of private mortgage insurance and FHA loan insurance premiums-through 2014. That provision in the tax code had been scheduled to terminate at the end of 2007.

To pay for the lost federal tax revenues caused by the debt relief and insurance premium changes, the House bill would narrow what some tax reformers claim is a loophole in the current code: It would restrict future capital gains exclusions on second homes that are converted to principal residences.

Under current rules, purchasers of second homes can convert them to principal residences, live in them for two years, and take the full $250,000/$500,000 exclusions available for principal residences, even though portions of their gains are attributable to periods when the property was used as a vacation home, not a principal residence. Effective Jan. 1, 2008, the House bill would reduce the exclusion based on the ratio of years of use as a principal residence to the total time of ownership.

If a taxpayer owned a vacation home for five years, but lived in it as a principal residence only for the final two years prior to sale, the maximum available exclusion would be reduced by three-fifths. For example, a $500,000 gain on the sale that would be eligible for the full exclusion under current law would be reduced by three-fifths, to $200,000.

Congressmen who represent areas with resorts and second home communities criticized the legislation as potentially harmful. The pending Senate bill does not contain either the second home or mortgage insurance provisions, suggesting the issue could end up as a point of dispute in an expected House-Senate conference committee on the legislation later this Fall.

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