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Capital Markets
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The 2007 Mortgage Relief Act

Background

The government and the mortgage industry have taken steps to limit the negative effects of the subprime mortgage crisis on the financial markets and the economy as a whole. Many of these initiatives have focused on lenders being able to modify mortgages so that distressed or potentially distressed debtors can continue to make payments on their mortgages. Since tax issues have made many modifications impractical, the IRS has been looking into ways to provide relief.

As discussed in the Capital Markets Accounting Developments Advisory 2007-9, the IRS in Revenue Procedure 2007-72 allowed, in certain instances, servicers to modify securitized mortgages without negative effects to the securitization entity. However, it did not address a significant tax issue associated with relieving debtors of their obligations to make full payments on their mortgages. Generally, if a lender forgives or cancels all or a portion of a debt, the cancelled portion is treated as taxable income to the debtor. This is often called cancellation or forgiveness of debt income (“COD income”).

SFG Observation: If the debtor is facing difficulty making payments on the mortgage, and the servicer or the lender forgives a portion of a debt, imposing an additional tax on the debtor will most likely eliminate any of the intended relief

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since after paying taxes the debtor may not have the financial ability to continue servicing the newly modified debt.

Illustration: A taxpayer owns a principal residence subject to a \$500,000 mortgage debt. As the interest rate on the mortgage increases and the taxpayer can no longer make the payments on the loan, the creditor forecloses and the home is sold for \$450,000 in satisfaction of the debt.

Under pre-2007 Mortgage Relief Act law, the debtor would have recognized \$50,000 of COD income that will require taxpayer to pay additional tax. The result would have been the same, if the creditor restructured the loan and effectively reduced the principal amount of the loan to \$450,000.

The 2007 Mortgage Relief Act is intended to provide relief, in limited situations, to the COD income that could arise from modifying certain mortgages.

SFG Observation: As described above, there are many circumstances under which debtor may incur COD income from debt forgiveness, cancellation or debt modification. Therefore, special care must be taken in evaluating these situations based on all the facts and circumstances.

2007 Mortgage Relief Act

On December 20th, 2007 president Bush signed the 2007 Mortgage Relief Act (H.R. 3648) to exclude from a taxpayer's gross income any COD income by reason of a cancellation (in whole or in part) of qualified principal residence indebtedness. This relief is capped at \$2 million (\$1 million for individuals filing separately) and is applicable to discharges of indebtedness occurring after December 31, 2006 and before January 1, 2010.

SFG Observation: This exclusion applies not only where taxpayers restructure their mortgage but also in situations where taxpayers lose their principal residence in a foreclosure.

This relief only applies to “qualified principal residence indebtedness”, which generally means indebtedness that is incurred to acquire, construct, or substantially improve the individual's principal residence and is secured by the residence.

SFG Observation: The exclusion rule will not apply to second homes, vacation homes, business property or investment property. Also, the exclusion rule will

not apply to discharges of second mortgages or home equity loans, unless the loan proceeds were used to acquire, construct or substantially improve the principal residence. The legislative history to the 2007 Mortgage Relief Act appears to provide that the relief may be available to refinanced mortgages.

Other Limitations

It is important to note that the principal residence exclusion only applies in situations when it relates to a decline in the property value or to the taxpayer's financial condition. In addition, the 2007 Mortgage Relief Act does not apply to taxpayers in the bankruptcy, since the bankruptcy rules have similar relief provisions.

Summary

The 2007 Mortgage Relief Act allows creditors to modify mortgages to prevent debtors from going into default without imposing a tax burden on the debtors. Consequently, the 2007 Mortgage Relief Act helps lenders take practical approach to the current credit crisis.

Questions

Please contact Trent Johnson at (202) 414-1484 for more information concerning either the 2007 Mortgage Relief Act or any other tax issue.

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