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Discharge of indebtedness excluded from taxable income

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Many taxpayers acquired their residences with highly leveraged mortgages during inflationary periods in the housing market. The belief was that as housing prices continued to escalate, home owners would be able to create equity through mortgage amortization, coupled with appreciation in their residences. However, when the housing market began to decline, these same taxpayers found that their mortgage debt exceeded the fair market value of the home. Based on the lender, taxpayers faced either foreclosure on the property or renegotiated the outstanding balance of the debt downward to reflect the current value of the property. In either case, Internal Revenue Code Section 61 requires that income from the discharge of indebtedness be included in gross income unless it is excludable under Code Section 108.

The Mortgage Forgiveness Debt Relief Act of 2007, (which will become law after it receives Presidential approval) includes a relief provision that applies to taxpayers, other than those covered by Code Section 108. This relief would apply to solvent taxpayers who have realized taxable income as a result of a full or partial discharge of qualified principal residence indebtedness. Under the bill, instead of recognizing income, the discharged indebtedness income would be deducted from the taxpayer's basis in the residence. The amount subject to this adjustment would be limited to the taxpayer's acquisition indebtedness, defined as debt incurred in the acquisition, construction, or substantial improvement of the principal residence and secured by the residence. Any amounts forgiven, in excess of the acquisition indebtedness, would still be taxable under Code Section 61.

The intent of this bill is to eliminate the tax liability on these restructurings or foreclosures, which will assist the taxpayer in re-establishing his financial position without suffering a tax on phantom income from this discharged indebtedness.

Norman Posner, CPA, managing partner, Samet & Co., Chestnut Hill, Mass. Ron Mutascio, CPA, MST, also with Samet, contributed to this article.

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