Mortgage relief and other tax breaks

While bank bailouts make news, taxpayers get some crumbs

By **Robert W. Wood**

Although the news media understandably focuses on the multibillion dollar federal bailouts of financial institutions, Joe the Taxpayer has at least received a few crumbs. In fact, over the last year, there have been a number provisions of federal tax law enacted that are designed to positively impact consumers. That is entirely appropriate, given the huge fallout related to the subprime mortgage meltdown and resulting economic black hole. Here's a brief review of Congressional tax law fixes that could impact you.

Mortgage debts

In December 2007, Congress enacted the Mortgage Forgiveness Debt Relief Act of 2007. The target of this act is home foreclosures, with specific help to alleviate the tax effects of treating a foreclosure as a real estate sale or disposition. The general rule – that a foreclosure is a sale – continues to apply. Sale treatment means that you may have to pay tax if you have a gain. True, there is a provision in the Internal Revenue Code to exclude the gain on the sale of a primary personal residence of up to $500,000 for a husband and wife filing jointly, or $250,000 for single filing status.

Thus, you get a tax break if you have a modest gain on your principal residence. On the flip side, however, if you experience a loss on the disposition of your residence, you can claim no tax deduction. The tax treatment of a foreclosure can seem even more unjust.

Under long established tax rules, when you experience mortgage debt forgiveness (you walk away from your home and are relieved of the debt), it is considered taxable income. This creates situations in which a taxpayer loses a house through foreclosure, and still has to pay income taxes. The relief of indebtedness represents a purely paper increase in wealth. Fortunately, for tax years 2007, 2008 and 2009, the federal law changed this rule to exclude up to $2 million of debt cancellation income from a foreclosure. It applies to foreclosures between Jan. 1, 2007 and Dec. 31, 2009.

Economic Stimulus Act

Next in the federal parade of relief legislation was the Economic Stimulus Act of 2008, passed in February 2008. This federal law provides a one-time refundable tax credit against personal income taxes of $600 per individual (plus another $300 for qualified dependents). This federal law triggered all of the economic stimulus checks (a whopping $93 billion mailed out) to millions of taxpayers (reportedly over 110 million taxpayers).

The Economic Stimulus Act also included provisions to raise the maximum loan amounts homebuyers could receive for mortgages backed by Fannie Mae and Freddie Mac, plus other agencies.

More Housing Relief

In May 2008, Congress passed the Food, Conservation & Energy Act of 2008. Buried in that law was some tax help to military veterans purchasing homes, authorizing states to issue qualified veterans mortgage bonds under which interest payments are tax-exempt. In July 2008, Congress passed the Housing and Economic Recovery Act of 2008. It contains a number of tax provisions that impact individual homeowners.

For one, there is a new repayable tax credit for principal residence purchases by first-time homebuyers. This is an odd tax credit, since most tax credits are never repaid. This new tax credit has to be repaid to the federal government in equal installments over 15 years, without interest. In effect, this is an interest-free loan from the federal government for qualified first-time homebuyers.

There are definitions and technical rules, but if you qualify, the credit is equal to 10 percent of the purchase price of the residence, up to a maximum of $7,500 for a single person or a married couple filing jointly (or $3,750 for a married person filing separately). The credit is phased out for individuals with certain modified adjusted gross income (for joint filers, generally the phase-out is for combined gross income between $150,000 and $170,000).

This repayable tax credit applies to residences bought between April 9, 2008 and July 31, 2009. Normally, you are to claim the credit for the year of purchase, but in limited circumstances, you can reach back. There are timing years on repayment, too, and rules covering what happens if you sell the home or cease to use it as a principal residence.

There are likewise rules about involuntary conversions (destruction, theft, condemnation, etc.). The credit is not available to nonresident aliens, nor to buyers who finance with tax-exempt revenue bonds.

Standard deduction changes

Another change in the 2008 Housing and Economic Recovery Act concerns individual taxpayers who do not itemize deductions (non-itemizers). For the 2008 tax year only, taxpayers who do not itemize deductions can increase their standard deduction to account for regular state property taxes assessed by state or local governments. This increase in the standard deduction can be the amount of the state and local property taxes or $500 (or $1,000 for joint filers), whichever is less. This tax gross-up for non-itemizers also applies to owners of cooperative apartments.

Hurricane help

There have been several federal laws specifically designed to help victims of Hurricanes Katrina, Rita and Wilma. The 2008 Housing and Economic Recovery Act also has some hurricane relief. For one, this act expands casualty loss tax relief for owners of homes that were damaged by the hurricanes in 2005.

If you had hurricane damage, you probably need to see someone who specializes in this area. There are a number of different federal laws, including the Gulf Opportunity Zone Act passed in late 2005. However, the 2008 Housing and Economic Recovery Act contains some additional relief, allowing taxpayers the claimed a 2005 casualty loss deduction to amend their 2005 returns.

AMT relief

The 2008 Housing and Economic Recovery Act also tinkers with the dreaded alternative minimum tax, or AMT. For one thing, interest on certain tax-exempt bonds issued after July 30, 2008 is no longer considered a tax preference item. Moreover, certain exempt facility bonds that are part of a larger issue from which at least 95 percent of the net proceeds are used to provide qualified residential rental projects, qualified mortgage bonds and qualified veterans' mortgage bonds, have also been deleted. There are reforms for real estate investment trusts as well.

Of course, as this short list should indicate, the AMT is still largely intact. Look for more tinkering with the AMT in the future, though outright repeal of the AMT may just be too expensive to happen anytime soon.

Low-income housing credits

The 2008 Housing and Economic Recovery Act liberalizes some rules surrounding low income housing tax credits. These credits are designed to stimulate development of low income property, Bear in mind that it is the developer or owner of property that gets the credit.

Military personnel

Finally, the 2008 Housing and Economic Recovery Act reinforces some protections for military personnel regarding mortgage foreclosure. For example, a service member can request that a mortgage lender set the interest rate at no more than 6 percent while he or she is on active duty, and the lender must comply.

Conclusion

None of these provisions of federal law is likely to radically alter the economy. Nevertheless, some of them are pretty significant. Tax relief from up to $2 million worth of discharge of indebtedness income is perhaps the most widely applicable provision. The repayable tax credit for first time homebuyers is also significant. We can probably look for additional provisions in the future, especially targeted at housing.

ROBERT W. WOOD, *a member of the State Bar of Montana, practices law with Wood & Porter, San Francisco (www.woodporter.com), and is the author of Taxation of Damage Awards and Settlement Payments (3d Ed. Tax Institute 2005 with 2008 update), and Legal Guide to Independent Contractor Status (4th Ed. Tax Institute 2007), both available at www.taxinstitute.com.*