Iowa State University
CALT
Center for Agricultural Law and Taxation
2321 N. Loop Drive, Ste 200 • Ames, Iowa 50010 www.calt.iastate.edu

Mortgage Foreclosure Tax Issues

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- by Roger McEowen*

Overview

Numerous factors have contributed to the current problems in the mortgage and housing industries. In large part, many of the problems stem from home buyers, mortgage companies and investors making bad decisions and either not understanding clearly or misusing some of the new and valuable financial innovations that have become available in recent years.[1] Consequently, credit and housing markets are going through a period of painful adjustment, with the result that some homeowners will face foreclosure.

Foreclosure can result in unexpected tax consequences to the debtor, with the precise impact depending on the type of debt involved, state law, and whether the foreclosure is structured as a "short sale." In addition, mortgage foreclosure can have tax consequences to the lender.

On Sept. 17, IRS issued a news release announcing that it has added a frequently asked questions (FAQ's) section on its website devoted to tax issues facing taxpayers who lose their homes due to foreclosure.[2] In the news release, IRS also reassured homeowners that while mortgage workouts and foreclosures can have tax consequences, special relief provisions exist to "reduce or eliminate the tax bite for financially strapped taxpayers who lose their homes." In addition, there may be viable alternatives to foreclosure that don't carry the same negative tax consequences.

The current problems in the credit and housing markets have also caught the attention of the Congress and the Administration. Legislation has been proposed that would alter the tax consequences of mortgage foreclosure.

Tax Consequences to the Debtor

Classification of the indebtedness. An important part of debt resolution is the income tax consequences to the debtor. Gross income generally includes "all income from whatever source derived."[3] This includes cancellation of debt income (CODI).[4] When a foreclosure occurs, there are two major categories of income tax consequences – (1) gain or loss if the property is transferred to the lender in satisfaction of indebtedness; and (2) possible CODI to the extent debt discharged exceeds the fair market value of property that the debtor gives up.

As a starting point, the tax impact of mortgage foreclosure is heavily dependent on the type of debt involved. If the debt is "recourse," the collateral serves as security on the loan. If the collateral is insufficient, the debtor is personally liable on the obligation and the debtor's non-exempt assets are reachable to satisfy any deficiency. If the debt is nonrecourse, the collateral again serves as security on the loan. But, if the collateral is worth less than the balance on the debt, the debtor is not personally liable for the balance. So, the creditor must look solely to the collateral in the event of default.

State law determines the type of indebtedness involved. In many states, home mortgages are classified as recourse debt, but California, for example, treats mortgages that are used to purchase a residence as nonrecourse (but, mortgages from refinancing a previous mortgage are usually recourse).

Nonrecourse debt. When a nonrecourse mortgage is foreclosed, a simple one-step process is involved. The property is treated as being sold for the balance of the mortgage.[5] Thus, the entire difference between the income tax basis of the property (that is transferred to the creditor) and the amount of the debt discharged is gain (or loss). There is no CODI.[6]

> **Note:** In the IRS FAQ, Q and A No. 3, IRS states, incorrectly, that CODI is "not taxable in the case of non-recourse loans."The correct statement should be that foreclosure of a nonrecourse loan does not result in CODI.

Recourse debt. The income tax consequence on foreclosure of a recourse mortgage is treated taxwise as if the property is sold to the creditor with the sale proceeds applied on the debt. Thus, a two-step process is involved – (1) there is no gain or loss (and no other income tax consequence) up to the income tax basis on the property, but the difference between fair market value and the income tax basis is gain or loss;[7] and (2) if the indebtedness exceeds the property's fair market value, the difference is CODI.[8] So, the foreclosure of a recourse mortgage (as well as a transfer as a result of an agreement between the parties) is treated as a sale up to the point of the property's fair market value.[9] If the lender forgives the balance of the mortgage, that amount is CODI and is taxed at ordinary income rates.[10]

For recourse debt, the tax consequences of mortgage foreclosure are heavily dependent on a determination of the property's fair market value. But, determining exactly what the FMV of the property is may not be an easy task. If the taxpayer surrenders property to a creditor in exchange for cancellation of debt in a foreclosure sale, absent clear and convincing proof to the contrary, the FMV will be presumed to be the sale price at the foreclosure sale.[11]

> **Note:** Unless a taxpayer rebuts this presumption, the amount bid at the foreclosure sale will be deemed to be the property's fair market value. Lenders frequently bid an amount higher than the property's fair market value. A taxpayer in an appropriate case should obtain appraisal evidence at the time of sale if the value of property is less than the amount bid at foreclosure.[12]

However, if the transfer is in lieu of foreclosure and the creditor sells the home shortly thereafter, the taxpayer will have to determine the property's selling price.[13]

Nonrecognition of gain. Any taxable gain triggered on foreclosure of the taxpayer's principal residence is eligible for exclusion under I.R.C. §121 – that's up to $250,000 for a taxpayer filing as a single person and $500,000 on a joint return.[14] The taxpayer must satisfy the occupancy and use requirements of the statute – the taxpayer must own the home and use it as the taxpayer's principal residence for at least 2 out of the previous five years.[15] There are exceptions from the two-year rule if the sale of the residence is on account of a change in the taxpayer's employment, health or "unforeseen circumstances." IRS, in its FAQ, did not say whether it would treat foreclosure of a residence as an "unforeseen circumstance."[16]

As is the case with foreclosure of nonrecourse debt, if the holding period requirement is met and the residence was the taxpayer's principal residence, the foreclosure amount representing gain is tax-free (up to $250,000 on a single return, $500,000 on a joint return), but the cancellation of debt would generally be taxable as ordinary income.[17]

Nonrecognition of CODI.[18] In some instances, CODI is not taxable.

Insolvency. CODI is not taxable if the debtor is insolvent (both before and after the transfer of property and transfer of indebtedness) and not in bankruptcy.[19] But, the amount of CODI that can be excluded from income is limited to the extent of the debtor's insolvency – if the amount of debt discharged exceeds the amount of the insolvency, income is triggered as to the excess.

The determination of the taxpayer's solvency is made immediately before the discharge of indebtedness. "Insolvency" is defined as the excess of liabilities over the fair market value of the debtor's assets. Both tangible and intangible assets are included in the calculation. Likewise, both recourse and nonrecourse liabilities are included in the calculation, but contingent liabilities are not. The separate assets of the debtor's spouse are not included in determining the extent of the taxpayer's insolvency. Historically, the courts have held that property exempt from creditors under state law is not included in the insolvency calculation. However, the IRS ruled has ruled to the contrary,[20] and the Tax Court has agreed.[21]

Bankruptcy. A debtor in bankruptcy need not report CODI,[22] but must reduce tax attributes and reduce income tax basis.[23] However, it is critical that the mortgage is foreclosed and the property is completely out of the debtor's name *before* the bankruptcy discharge occurs.

Deductible items. Any portion of a cancelled debt, including interest, which would have been deductible if paid, is not subject to federal income tax. Thus, the portion of cancelled debt that is attributable to accumulated deductible mortgage interest is not taxable.

"Short-Sale" Transactions

A "short sale" occurs when a homeowner sells the home for less than the existing mortgage balance. The seller then tries to get the lender to forgive the unpaid balance.[24] Typically, a debtor considers the use of a short sale in lieu of foreclosure in an attempt to protect their credit history.

A short sale is taxed under the same rules as foreclosures are taxed. If the underlying debt is recourse, the cancelled debt is not satisfied with the surrender of the property. Thus, any debt not satisfied with the sale proceeds is taxable as CODI.[25] That means that the tax consequences would be the same as mortgage foreclosure involving a recourse debt.[26] If the short sale involves nonrecourse debt, and the seller and the buyer require cancellation of the debt by the lender as a condition of the sale, the debt cancellation is included in the sale proceeds, like for a foreclosure.[27] So, a short sale can be a viable alternative to a foreclosure for debtors with nonrecourse debt and who qualify for the exclusion from income of the gain from the sale of a principal residence.

Drop in Value of Home – Deductibility and Timing of a Loss

In the present real estate market it is entirely possible that the fair market value of a home may have dropped beneath its purchase price if the purchase occurred relatively recently. If foreclosure then occurs (or a short sale transaction is entered into), and the underlying debt is nonrecourse, the difference between the mortgage balance at the time of foreclosure and the taxpayer's basis in the home[28] is a non-deductible personal loss if the residence is the taxpayer's principal residence.[29] If the debt is recourse and a foreclosure or short sale occurs, CODI results on the difference between the fair market value of the home and the existing mortgage balance, and a non-deductible personal loss (if the home is the taxpayer's personal residence) is triggered as to the difference between the taxpayer's basis in the home and the home's fair market value.

Regardless of whether the debtor is an accrual-basis or cash basis taxpayer, any loss resulting from the foreclosure is treated as occurring when the foreclosure (or transfer in lieu of foreclosure) takes place[30] If the debtor exercises the right to redeem and recovers possession of the property, no gain or loss is realized.[31] Also, if state law provides for redemption rights, the debtor may avoid postponement of any foreclosure gain or loss by quitclaiming the redemption rights.[32]

If the fair market value of the foreclosed property is less than the outstanding mortgage and the mortgagee releases the mortgagor from his obligation to pay the deficiency, any CODI which the mortgagor realizes is reported in the year the mortgagee provides the release.

Tax Consequences to the Mortgagee

In general. A mortgagee may face two possible tax impacts when property is foreclosed. First, assuming the mortgage is a bad debt, the mortgagee may have a bad debt deduction in the year of foreclosure on the outstanding portion of the mortgage,[33] and can take a partial bad debt deduction if the mortgage is partially worthless and the mortgagee charges off the worthless portion.[34] Second, the mortgagee may recognize gain or loss on the final disposition of the property.

To the extent that amounts received from a foreclosure sale of mortgaged property to a third party exceed the mortgagee's total claim, (including all costs associated with the foreclosure), the excess is normally paid to the mortgagor. So, it is unusual for a mortgagee to realize a gain from a foreclosure sale.[35] However, the mortgagee could experience gain if the mortgagee originally purchased the mortgage debt at a discount or had previously taken a partial bad debt deduction which reduced the mortgagee's basis in the loan.

Nonrecourse debt. In the case of a nonrecourse mortgage where the mortgagee purchases the mortgaged property in a foreclosure sale, the mortgagee has a taxable gain or loss to the extent of the difference between the bid price[36] and the mortgagee's basis in the mortgage.[37]

Recourse debt. If the mortgagee purchases mortgaged property in a foreclosure sale, and the mortgage is recourse, the mortgagee has the right to try to recover the deficiency from the mortgagor. Since recovery on a deficiency judgment would make the mortgagee whole, any loss which the mortgagee might have can only be taken in the foreclosure year if it can be shown in that year that the deficiency is uncollectible.[38] Otherwise, the mortgagee subtracts the foreclosure recovery from its original debt basis to determine its basis in the deficiency. The mortgagee then defers reporting gain or loss until the collectibility (or uncollectibility) of the deficiency is determined.[39] Accrued interest may be included as part of the deduction allowable with respect to a mortgage foreclosure, but only if the interest has been reported as income.[40]

Handling expenses of foreclosures and repossessions. Court costs, legal fees and other foreclosure costs related to property sold at foreclosure reduce the proceeds that the mortgagee receives. Any expenses and liens the mortgagee pays to protect the mortgaged property before the foreclosure sale will be added either to the mortgagee's basis for the loan or to its basis for the acquired property, depending upon when they are paid. Amounts paid *before* foreclosure are added to the mortgagee's loan basis, while outlays *during* the foreclosure proceedings are added to the mortgagee's property basis or to the deficiency judgment if the mortgagee does not acquire the property.[41]

A foreclosure by a prior lien holder generally eliminates a mortgagee as a secured creditor, but any resulting loss is not deductible by the mortgagee until the junior note (previously secured by the foreclosed property) is proven to be worthless.[42]

Alternatives to Foreclosure

In any given situation, there may be some alternatives to foreclosure that can be utilized that may, depending on the circumstances, have a better tax consequence.

Restructuring the debt. It may be mutually beneficial for the parties to restructure the debt. A substitution of a new debt instrument in satisfaction of outstanding indebtedness is treated as satisfaction of the outstanding indebtedness for an amount equal to the issue price of the new debt instrument.[43] That may trigger CODI for the debtor equal to the difference between the new debt instrument's issue price and the adjusted issue price of the old debt instrument. Alternatively, if the debt is actually cancelled, the debtor may realize ordinary income to the extent of the discharge.

Modifications of the indebtedness. Other restructuring alternatives may include an extension of the mortgage term, waiver of current debt service payments and addition of unpaid interest to the principal balance of the mortgage. If the modification is not material, these types of adjustments have historically been treated as nonrecognition events.[44] But, the U.S. Supreme Court has created a rather low threshold in determining whether a modification of terms of an outstanding debt obligation is material enough to be treated as a deemed exchange of old debt for new debt with resulting tax consequences.[45] Likewise, the regulations specify that there is a realization event if there is a "modification" in the debt instrument which is a "significant modification."[46] Most temporary forbearances of a mortgagor's failure to perform are not considered significant modifications and, therefore, do not result in a realization event.[47]

The bottom line is that the restructuring of an existing loan by entering into a loan modification agreement may cause the lender to be treated as having disposed of the original mortgage, and the borrower may have CODI if the principal amount of the old loan exceeds the principal amount of the new one. The modification may also trigger the original issue discount rules that would treat a portion of the new debt principal as imputed interest. If the principal of the old debt is greater than the imputed principal of the new debt, a solvent borrower generally realizes CODI.[48]

Installment sale. Installment sale reporting may be used to defer recognition of a part of the gain until the installment payments are collected in the future. But, the major limitation is that any excess of the mortgage balance over the adjusted basis of the property is treated as payment received in the year of sale.

Like-kind exchanges. Like-kind exchanges may be used as an alternative to foreclosure.[49] However, it may be difficult to find property suitable for exchange. In addition, the debtor's property typically has a relatively high outstanding mortgage balance, along with a low equity value. So, the debtor would have to include some cash along with the property in the trade and trade up to a higher-value property. That may not be possible.

Constructive Receipt Issues in Debt Restructurings

Constructive receipt of income may occur when a mortgage or other debt is extended or restructured. Constructive receipt of income occurs when the taxpayer has an unrestricted right to receive the income, is able to collect it, and the failure to do so results from the exercise of the taxpayer's own choice.[50] If the debtor is unable to pay a mortgage note when due, the mortgagee has not constructively received income. If, however, a note is extended or restructured as an accommodation to a debtor who is otherwise able to pay, constructive receipt of the entire principal due may occur on the due date of the note.[51] To avoid constructive receipt in this situation, any extension or superseding agreement with respect to the loan must be agreed to before the existing mortgage note or loan becomes due.[52]

Proposed Legislation

Legislation has been proposed that would exclude CODI from gross income that is triggered by the discharge (after December 31, 2006) of "qualified principal residence indebtedness."[53] The House bill, which would *permanently* exclude CODI from gross income, passed by a wide margin on October 4, 2007.[54] Under the bill, "qualified principal residence indebtedness" is defined as acquisition indebtedness (as defined by I.R.C. §163(h)(3)(B), but without regard to any dollar limitation) with respect to the debtor's principal residence (as defined for purposes of I.R.C. §121).[55] The debtor's basis in the residence would be reduced by the amount excluded from income. Also, the exclusion would not apply to debtors in bankruptcy, but it would apply to insolvent debtors unless the debtor elects to have the exclusion for insolvent debtors apply. But, the exclusion would not apply to the discharge of a loan if the discharge is on account of services performed for the lender.

The legislation would also extend the existing deduction for private mortgage insurance to amounts paid or accrued after 2007, but only with respect to contracts entered into after 2006 and before 2015.[56]

To pay for the new tax break, beginning in 2008, the legislation limits the existing I.R.C. §121 exclusion for gain attributable to the sale of a principal residence to only those periods during which the taxpayer actually used the residence as the taxpayer's principal residence.[57]

Policy Implications of the Proposed Legislation

Completely eliminating the tax on CODI attributable to a debtor's principal residence is not the correct policy approach. The value of the cancelled mortgage is a beneficial gain to the former borrower which should be subject to tax – it is an accession to wealth. Thus, complete elimination of the tax on CODI amounts to a windfall (at taxpayer expense) for debtors who, in many respects, made poor economic decisions.[58] Existing tax law already provides an incentive for homebuyers to borrow too much for mortgage indebtedness, and making mortgage debt tax free would only further increase that incentive.[59] Perhaps a better approach would be to tax CODI at preferential long-term capital gain rates rather than ordinary income rates. When a lender cancels a mortgage debt, the lender suffers a capital loss. It logically follows that the borrower has received a capital gain and should be taxed accordingly. [60]

From a broader perspective, requiring loan applicants to undergo an approval process based on genuine ability to pay might go a long way to avoiding a similar problem in the future.[61]

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*Leonard Dolezal Professor in Agricultural Law, Iowa State University, Ames, Iowa, and Director of the ISU Center for Agricultural Law and Taxation. Member of the Iowa and Kansas Bar Associations and licensed to practice in Nebraska.

[1] Also involved are homeowners that borrowed against the perceived equity in their residence (often via 125 percent home equity loans and adjustable rate mortgages that are contractually beginning to adjust the interest upward) to buy consumable, non-necessary goods – in effect, attempting to "monetize" their home through borrowing (or repay unsecured credit card obligations). Likewise, some lenders were overly eager to extend credit at relatively higher interest rates to people with not-so-good creditworthiness (so-called "subprime loans"), and borrowers who bought properties to "fix and flip" on the expectation that the real estate market would only continue to go up

[2] IRS News Release 2007-159 (Sept. 17, 2007).

[3] I.R.C. §61(a).

[4] I.R.C. §61(a)(12). Under I.R.C. §1001(a), gain realized from the sale of property equals the excess of the amount realized over the taxpayer's adjusted income tax basis in the property. The amount realized
from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

[5] See Comr. v. Tufts, 461 U.S. 300 (1983), *rev'g, sub. nom.*, Tufts v. Comr., 651 F.2d 1058 (5th cir. 1981); Helvering v. Hammel, 311 U.S. 504 (1941).

[6] One significant difference between nonrecourse and recourse mortgages is that, with a nonrecourse mortgage, the amount realized on foreclosure, or a transfer in lieu of foreclosure, is never less than the outstanding debt. I.R.C. §7701(g). Thus, the debt is not treated as "canceled" and the debtor does not have CODI.

[7] *See, e.g.,* Emmons v. Comr., T.C. Memo. 1998-173.

[8] Treas. Reg. §1.1001-2(a)(1).

[9] For recourse debt, the amount realized generally cannot exceed the fair market value of the property. Rev. Rul. 90-16, 1990-1 C.B. 12; Treas Reg. § 1.1001-2(c). This limitation applies even if the amount bid at the foreclosure sale exceeds the property's fair market value. Frazier v. Comr., 111 T.C. 243 (1998).

[10] Treas. Reg. §1.61-12. That amount is reported to the taxpayer on Form 1099-C, Box 7.

[11] See Community Bank v. Comr., 819 F.2d 940 (9th Cir. 1987), *aff'g,* 79 T.C. 789 (1982); Frazier v. Comr., 111 T.C. 243 (1998); Maracaccio v. Comr., T.C. Memo. 1995-174.

[12] *See, e.g.,* Frazier v. Comr., 111 T.C. 243 (1998).

[13] One of the IRS FAQs suggests that taxpayers who don't agree with the information on a Form 1099-C should contact the creditor and have the creditor issue a corrected form if the information is incorrect.

[14] I.R.C. §121(b)(1)-(2).

[15] I.R.C. §121(a).

[16] While IRS has liberally interpreted "unforeseen circumstances" in recent years, a drop in market value of a home would likely not meet the test, and neither would readjustment of the interest rate of an adjustable rate mortgage.

[17] I.R.C. §61(a)(12).

[18] The amount of CODI that is not taxable is claimed on IRS Form 982 (Reduction of Tax Attibutes Due to Discharge of Indebtedness) by checking the box at Line 1(b) in Part I and indicating the amount of debt forgiveness that is exempt from federal income tax on Line 2. Form 982 must be attached to the taxpayer's Form 1040 for the year in which the debt is cancelled.

[19] I.R.C. §108(a)(1)(B). But, insolvent debtors must reduce tax attributes and reduce the income tax basis of property. See I.R.C. §108(b).

[20] Priv. Ltr. Rul. 199932013 (May 4, 1999), *revoking*, Priv. Ltr. Rul. 9125010 (Mar. 19, 1991); Tech. Adv. Memo. 199935002 (May 3, 1999).

[21] Carlson v. Comr., 116 T.C. No. 9 (2001).

[22] *See, e.g.,* I.R.C. §§108(a)(1)(A).

[23] It is noted, however, that under The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. 109-8, 119 Stat. 23, it is more difficult for individuals to file bankruptcy than under pre-BAPCPA law.

[24] The "short sale" technique refers to a technique that has arisen out of the current mortgage foreclosure climate and is a new use of the term – it does not refer to the Internal Revenue Code definition of the term. Under the Code, a "short sale" involves the sale of a borrowed item to be replaced at a future date, usually a security. IRS has never applied the term "short sale" to a real estate sale transaction.

[25] Rev. Rul. 92-99, 1992-2 C.B. 35. See also, Treas. Reg. §1.1001-2(a)(2).

[26] In addition, it is questionable whether the lender would consent to the transaction and, in fact, forgive the debt.

[27] 2925 Briarpark Ltd. v. Comr., 163 F.3d 313 (5th Cir. 1999), *aff'g,* T.C. Memo. 1997-298.

[28] The fair market value of the property is disregarded for a non-recourse mortgage.

[29] The loss incurred is deductible only if the mortgage indebtedness was incurred in connection with property either held for investment or used in the debtor's trade or business. But, if the foreclosure proceeds are used to pay outstanding interest or property tax obligations, they will typically be deductible. *See, e.g.*, Malmstedt v. Comr., 578 F.2d 520 (4th Cir. 1978).

[30] Lamm v. Comr., 873 F.2d 194 (8th Cir. 1989). That is also the case if the debtor has a right of redemption under state law. *See, e.g.*, Securities Mortgage Co. v Comr., 58 T.C. 667 (1972); William C Heinemann & Co. v Comr, 40 B.T.A. 1090 (1939). But, IRS has taken the position that if the debtor has a statutory right to reaquire the property following foreclosure (i.e., redemption), the debtor's ability to deduct a loss is postponed until the right of redemption expires. Rev. Rul. 70-63, 1970-1 C.B. 36. However, if the foreclosure matter is in litigation, the year in which the litigation terminates is the year in which tax items are taken into account. Great Plains Gasification Associates, *et al.* v. Comr., T.C. Memo. 2006-276.

[31] Hotz v. Comr., 42 B.T.A. 432 (1940).

[32] Atmore Realty Co. v. Comr., B.T.A. Memo. 1942-248 (1948).

[33] I.R.C. §166(a). *See, e.g.,* Comr. v. Spreckels, 120 F.2d 517 (9th Cir. 1941). If the mortgage is a nonbusiness bad debt, subject to I.R.C. §166(d), the loss is a short-term capital loss.

[34] See generally I.R.C. §166(a)(2) and Treas. Reg. §1.166-3.

[35] A loss may be recognized for tax purposes in the year of foreclosure, even though the mortgagor has a right of redemption. See Securities Mortgage Co. v Comr., 58 T.C. 667 (1972); William C Heinemann & Co. v Comr, 40 B.T.A. 1090 (1939).

[36] The bid price usually is presumed to the the fair market value of the property. *See, e.g.,* Community Bank v. Comr., 62 T.C. 503 (1974), acq., 1975-2 C.B. (presumption upheld even where IRS claimed that bid price less than fair market value). See also Treas. Reg. §1.166-6(b)(2). But, the presumption does not apply when the mortgagee is the seller and is also the party foreclosing on the property. I.R.C. §1038 provides that when the seller/mortgagee reposseses property in satisfaction of the indebtedness, no loss is recognized and, under certain circumstances, gain may be recognized.

[37] The result is the same with a recourse mortgage if the bid price equals or exceeds the outstanding debt. The mortgagee's basis is determined by subtracting principal paid from the loan's face amount. I.R.C. §166(b); Treas. Reg. §1.166-1(d).

[38] Treas. Reg. §§ 1.166-6(a); 1.165-5(e). See also Estate of Jewett v Comr., T.C. Memo. 1949-163 (1949); Havemeyer v Commr, 45 B.T.A. 329 (1941), *acq* 1942-1 CB 8.

[39] See Treas. Reg. §1.166-6(a)(1).

[40] Treas. Reg. §1.166-6(a)(2); Federal Home Loan Mortgage Corporation v Comr., 121 T.C. 279 (2003) (in computing gain or loss from a mortgage foreclosure, taxpayer cannot increase adjusted cost basis in the mortgage by interest that accrued while taxpayer was tax-exempt).

[41] But see Heger v Comr., T.C. Memo. 1993-408, *aff'd*, 35 F.3d 561 (5th Cir. 1994), where payments made to avoid foreclosure were *not* allowed to be added to basis.

[42] Berenson v Comr., 39 B.T.A. 77 (1939), *aff'd* 113 F.2d 113 (2d Cir. 1940).

[43] I.R.C. §108(e)(10).

[44] Rev. Rul. 73-160, 1973-1 C.B. 365 (extension of maturity date of notes not a taxable transaction); Soter v Comr., T.C. Memo. 1968-43; Rev. Rul. 68-419, 1968-2 C.B. 196 (modification of purchaser's note to defer principal payment dates and increase interest rate not disposition or satisfaction of an installment obligation); Rev. Rul. 55-429, 1955-2 C.B. 252.

[45] Cottage Savings Assoc. v. Comr., 499 U.S. 554 (1991), *rev'g and rem'g*, 890 F.2d 848 (6th Cir. 1989).

[46] Treas. Reg. §1.1001-3. For this purpose, a modification is "any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise." Treas. Reg. §1.1001-3(c)(1).

[47] See Treas. Reg. §1.1001-3(c)(4)(ii), providing that a forbearance of under two years (and sometimes longer) is temporary for these purposes.

[48] I.R.C. §108(e)(11).

[49] I.R.C. §1031.

[50] Treas. Reg. §1.451-2(a); Saint Claire Corp. v Comr., T.C. Memo. 1997-171.

[51] This type of situation is likely to occur when real property is sold to related parties, to controlled entities, or to parties who are well-known to the seller.

[52] Martin v Comr., 96 T.C. 814 (1991); Oates v Comr, 18 T.C. 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir 1953); Saint Claire Corp. v Comr., T.C. Memo. 1997-171 (constructive receipt of entire remaining principal occurred when mortgage note was extended on the date it became due and obligor was otherwise able to pay).

[53] See S. 1394, "The Mortgage Cancellation Relief Act of 2007," introduced May 15, 2007, and H.R. 3648, "The Mortgage Forgiveness Debt Relief Act of 2007," introduced on September 25, 2007, and passed by the House on October 4, 2007.

[54] H.R. 3648 passed by a vote of 386-27. If the legislation is being enacted to address the current situation in the mortgage and housing industries, a question is raised as to why the House deemed it necessary to craft permanent relief.

[55] Thus, loans for purchasing and improving a residence would qualify, but equity loans would not.

[56] This relief would apply (at least partially) to taxpayers with adjusted gross income of less than $55,000 (single return) or $110,000 (joint return).

[57] Thus, the I.R.C. §121 exclusion of gain attributable to the sale of a rental or vacation property would be reduced beginning in 2008. So, even if the legislation passes, the reduction in the exclusion would only be for "nonqualified" use after 2007. That would give taxpayers the remainder of 2007 to move into a vacation home or rental property, live there for the minimum two-year period, and qualify for the full exclusion.

[58] On October 3, 2007, the Administration, while expressing support for H.R. 3648, also urged lawmakers to narrow the scope of the bill. Such narrowing, the Administration noted, should be in the form of temporary relief and should not put in place tax policy that would influence future borrowing behavior.

[59] A related economic effect of increased debt financing would be an increase in the market price of new and existing homes.

[60] It is noted that the alternative minimum tax (AMT) may be imposed on the portion of capital gains that is excluded from income. Thus, reclassifying CODI as capital gain income which is then excluded under I.R.C. §108 could create an AMT preference item. The Congress, from a policy perspective, would have to consider whether an amendment to the AMT statute would be in order.

[61] Clearly, there is a need for additional emphasis on education concerning financial matters. To this end, the Bush administration announced on August 31, 2007, that it would create a Presidential Council on Financial Literacy to help raise awareness of the financial issues surrounding home buying and financing.