

MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007 (eff. 12/20/07).
ABA Tax Section, Pro Bono Committee,
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A. Pre-Mortgage Forgiveness Debt Relief Act of 2007 and Basis Rules Under I.R.C. §108

1. What is DEBT?
Any indebtedness for which the debtor is liable, or which attaches to property the debtor holds.
2. Forgiven or cancelled debt, is generally included in gross income for tax purposes.
3. Exceptions to this general rule were limited to:
 - a. when the cancellation of debt takes place in a bankruptcy case.
 - 1) if the debtor is within the bankruptcy court's jurisdiction
 - 2) the cancellation of debt is granted by the court, or is a result of a confirmed plan
 - 3) none of this debt is included in income
 4. Tax attributes (losses, credits, basis) must be reduced by the amount of debt excluded from income
 - b. when the cancellation of debt takes place when you are insolvent.
 - 1)insolvency = debts exceed FMV of assets
 - 2) the amount of your insolvency determines the excluded portion of the forgiven debt
 - 3) again the amount of debt excluded from income reduces tax attributes
 - 4) Ex. IF \$5000 debt is cancelled,
AND your debts were \$30,000,
AND the FMV of your assets was \$28,000,
THEN - \$2000 of the \$5000 cancelled debt is excluded from gross income
AND - \$3000 is included in gross income
 - c. when the cancelled debt is "qualified farm debt"(incurred in the operation of a farm).
 - d. when the cancelled debt is "qualified real property business debt"(certain debt connected with business real property.)

4. Tax Attributes reduced by cancelled debt (in order):
 - a. NOL
 - b. General business credit carryovers
 - c. Minimum tax credit
 - d. Capital losses
 - e. Basis
 - f. Passive activity loss and credit carryovers
 - g. Foreign tax credits
5. Basis reduction Rules:
 - a. Reduce the basis at the beginning of the tax year following the year the debt was cancelled.
 - b. Basis reduction can't be more than the total basis after the debt cancellation minus the total liabilities after the cancellation, unless you elect to reduce basis first.
 - c. There is no basis reduction in exempt property in a bankruptcy.
 - d. You can elect to reduce basis in depreciable property first, before reducing other attributes.
 - e. If basis in property is reduced and later sold, the gain from the part that is from the basis reduction is ordinary income.

B. Post-Mortgage Forgiveness Debt Relief Act of 2007

6. I.R.C. §108(a)(1)(E) was added to the above exclusions from income.
 - a. Excludes from income cancelled "personal residence acquisition debt"
 - b. Up to \$2,000,000 (\$1,000,000 for married filing separate taxpayers)
 - c. Only applies to debt cancelled in 2007, 2008 and 2009
 - d. Only applies to cancelled debt used to buy, build, or substantially improve you principal residence, or to refinance debt incurred for those purposes.
(I.R.C. §163(h)(3)(B))
 - e. Re-financed debt is excluded only to the extent of the qualifying principal mortgage prior to the re-finance.
 - f. If the cancelled debt includes qualified and non-qualified indebtedness, the exclusion applies only to the portion of the cancelled debt in excess of the non-qualified part of the debt. I.R.C. §108(h)(4).
 - f. Does not apply if discharge is granted on account of services performed for the lender or any other factor not related to a decline in the value of the house or the financial condition of the debtor.
 - g. The only tax attribute reduced is the basis in the principal residence. I.R.C. §108(h)
7. If the taxpayer is insolvent when the debt is cancelled, he/she can elect to apply the insolvency exclusion, if no election is made, the principal residence exclusion takes precedence.
8. This exclusion does not apply to second homes, rental property, business property, credit cards, car loans, etc.

9. You must report the cancelled debt on your tax return by using Form 982 (Attached)
10. How do you know if debt has been cancelled?
 - a. the lender has issued a Form 1099-C
 - b. the property has been foreclosed????
 - c. the lender has a deficiency judgment?????
 - d. the lender has accepted a short sale????
 - e. the lender has accepted a deed in lieu of foreclosure?????

C. Other Mortgage Relief

11. HOPE NOW/Paulson Mortgage Modification Plans.
 - a. Announced by Treas. Secy. Paulson on December 6, 2007.
 - b. Purpose: help avoid foreclosures on subprime adjustable rate mortgages.
 - c. Loan Modification = a written agreement between the lender and the homeowner that changes original terms of the note to help bring a defaulted loan current and prevent foreclosure.
 - d. Can be short term, long term or life of loan.
 - e. Can reduce interest rate, principal amount, change from adjustable to fixed, extend the term, or capitalize delinquent payments.
 - f. Sets up streamlined procedure for processing loan modifications.
 - g. Limited to those borrowers who are current on the loan at the starter rate/terms, then default after the initial rate reset.
 - h. Eligible loans: Only subprime first lien ARM loans,
originated between Jan 1, 2005 and July 31, 2007
Which are included in securitized pools AND
Have initial interest rate reset (36 months or less) between Jan 1, 2008
and July 31, 2010.
 - i. NOT APPLY: borrowers in foreclosure with resets before 1/1/08
 - j. It is a voluntary program for lenders.
 - k. Has not proven very successful
12. PROJECT LIFELINE
 - a. Announced on Feb. 12, 2008 by Secretary Paulson
 - b. Provides a 30 day temporary delay of foreclosure
 - c. Applies to borrowers who are at least 90 day delinquent, but not more than 30 days from scheduled foreclosure, and not in bankruptcy.
 - d. is billed as a "foreclosure pause" to try to workout an agreement.
 - e. is not as limited as HOPE NOW - applies to delinquent loans and other than subprime.
13. Pending legislation.
 - a. House and Senate bills trying to allow modification of home loans in bankruptcy

which would repeal the prohibition enacted in 2005.

Other resources:

Institute for Foreclosure Legal Assistance. www.foreclsourelegalassistance.org

U.S Dept. Of Housing and Urban Devt.

1-800-569-4287 www.hud.gov/offices/hsg/sfh/hcc/nrhci.cfm

NeighborWorksAmerica

202-220-2300 www.nw.org

National Community Reinvestment Coalition

202-628-886 www.ncrc.org

Mortgage Bankers Association

www.homeloanlearningcenter.com (“Foreclosure Prevention Resource Center”)

D. What if the IRS is foreclosing or filing a petition for approval of an administrative levy on the principal residence under I.R.C. §6334(e)(1)?

(I) Administrative Levy.

14. The IRS, with approval of a US District Court judge can levy on a personal residence to satisfy tax liabilities in excess of \$5,000. I.R.C. §§6334(a)(13)(B), 6334(e)(1).

15. Under this process the taxpayer has 25 days to object and demonstrate:

a. that the liability has been paid

b. you have other assets from which the liabilities can be satisfied, or

c. the IRS did not follow the rules with respect to the levy.

16. If an objection is filed, an expedited hearing is scheduled.

17. The taxpayer either enters into an agreement with the IRS for a delay to either sell or refinance, or loses his/her home.

(II) Suit to Reduce the tax lien to judgement and foreclose on the personal residence.

18. The IRS has the authority to enforce a lien and subject property to payment of taxes pursuant to I.R.C. §§7402 and 7403.

19. The judgement obtained as a result of this action is effective for as long as a judgement on real property is effective according to state law.

20 Suit must be filed prior to expiration of the statute of limitations for collection. I.R.C. §6502(a).

E. Other Methods of Resolving Tax Liabilities with the IRS.

21. To avoid the loss of the personal residence to the IRS, other means or resolving tax issues should be explored:

A. OFFERS IN COMPROMISE:

An Offer in Compromise is a written agreement entered into between the taxpayer and the Internal Revenue Service, (“IRS”), to satisfy unpaid tax liabilities for less than the full amount due.¹ The objectives outlined by the IRS in accepting OIC’s are: to collect the most amount, at the earliest time, with the least cost to the IRS; to reach resolution in the best interests of the IRS and the taxpayer; to provide the taxpayer with a fresh start toward voluntary compliance; and to collect money otherwise not available.²

There are three types of OIC. First, there is an OIC that is based on doubt as to liability wherein the taxpayer does not really owe the tax. Examples include innocent spouse, incorrect deficiency, trust fund recovery penalty incorrectly assessed, or payments not properly applied.³ The second class of OIC is based on doubt as to collectibility. The taxpayer in this second class cannot pay the full liability from assets and income, or there are special circumstances that allow the taxpayer to make a “hardship offer”, even though he may be able to pay.⁴ The final type of OIC is entitled “effective tax administration.” In this type of OIC, the taxpayer may be able to full pay the tax, but such payment would cause an economic hardship or there are special circumstances.⁵

Each class of OIC is subject to its own requirements. The least rigorous is the first class, based on doubt as to liability. For this offer, the taxpayer must file a Form 656, but there is no requirement for a financial statement (Form 433-A or 433-B). Included with the OIC must be proof to support the bases for doubt as to liability. In addition, the taxpayer must be in full compliance for all periods subsequent to those included in the OIC, and remain in compliance for five years after the OIC is accepted.⁶ The OIC cannot be rejected under the compliance requirement just because the IRS may not be able to locate a return.⁷

OIC’s based on doubt as to collectibility are the most prevalent. To meet the initial requirements for this type of offer, the taxpayer must file Form 656 (Offer in Compromise), and fully completed financial statements, Forms 433-A and/or 433-B, with all attached documentation. The OIC must include all outstanding liabilities, including assessed and unassessed liabilities. It cannot include those taxes for which the collection statute (“SOL”) has already expired.⁸ The amount offered must be equal to the quicksale value of the equity in the taxpayer’s assets⁹ plus the present value of the monthly amount the IRS could collect (usually 48xIA monthly amount, unless there is a short SOL).¹⁰ And, just as in the first type of OIC, the taxpayer must be in full compliance for all periods after those covered in the OIC and remain in compliance for 5 years after OIC accepted.¹¹ In addition, the taxpayer must pay a \$150.00 processing fee, unless he or she can qualify as a low income taxpayer.¹²

The final class of OIC is entitled “effective tax administration” offer (“ETA”). The filing

requirements for this type of OIC are the same as those listed above for an OIC based on doubt as to collectibility.¹³ The only difference is that there must be exceptional circumstances which result in a determination that collection of the full amount of tax due would either: (a) create a hardship; or (b) be detrimental to voluntary compliance. That is, in the former, even though the taxpayer has the money to full pay the tax, if the tax were collected, the taxpayer would not be able to meet reasonable basic living expenses. With respect to the latter, collection would be so unfair and inequitable that other taxpayers would lose confidence in the system.¹⁴

Notwithstanding the unwieldy amount of paper required to process a successful OIC, the odds of acceptance are weighted against the taxpayer from the getgo. The IRS will reject an OIC if: (1) all of the documents are not properly submitted; (2) the taxpayer fails to submit any additional requested documents; (3) the amount offered is less than what could be expected to be collected; or if (4) there is a public policy reason to reject.¹⁵ In addition, even though the IRS is supposed to use the National Standard Expenses (“NSE”) (food, clothing, and miscellaneous), and the Local Standard Expenses (“LSE”) (housing) as a guide, rather than an absolute, there are very few instances in which any variance is allowed. According to the National Taxpayer Advocate’s Report for 2003, the IRS must justify acceptance of an OIC. On the other hand, rejection needs no support, merely a rejection letter.

Effective July 16, 2006, taxpayers submitting a “lump-sum” offer must make a 20% nonrefundable, upfront payment to the IRS. A lump-sum offer is any offer of payments made in five or fewer installments.¹⁶ A taxpayer filing a periodic payment offer must pay the first proposed installment payment with the OIC and continue to make payments while the IRS considers the OIC.¹⁷ A periodic payment offer means any offer made in six or more payments. None of these payments are refundable, but can be designated by the taxpayer as to their application. Low income taxpayers may qualify for waiver of these payments. Under the new OIC procedures, an OIC is deemed “accepted” if it is not withdrawn, returned, or rejected with 24 months of IRS receipt. The 24 months does not include any time during which the liability at issue is the subject of a dispute in any judicial proceeding.¹⁸

Once the OIC is accepted, if the taxpayer “defaults” during the five years following acceptance, the IRS will re-instate the tax, interest and penalties and re-commence enforced collection.

B. INSTALLMENT AGREEMENT:

In Installment Agreement (“IA”) is a written agreement to satisfy tax liabilities in installment payments.¹⁹ For an IA to be acceptable, the following requirements must be met: (a) the liability must be full-paid within the statute of limitations, except as described below in the “partial pay” IA;²⁰ (b) the taxpayer must be in full compliance during the term of the agreement;²¹ (c) the taxpayer must provide updated financial information upon request;²² and (d) the taxpayer must pay a \$43 fee.²³ Effective January 1, 2007, the fee has increased from \$43 to \$52 for IA’s that include automatic bank debit form of payment, and to \$105 for other new IA’s. In addition,

the fee to re-instate a defaulted IA will increase from \$24 to \$45.

Although the taxpayer is bound by the terms of the IA, the IRS can terminate or change the agreement if: (a) the taxpayer defaults in a payment;²⁴ (b) the taxpayer fails to file or pay a subsequent tax, including estimated tax payments;²⁵ (c) the taxpayer fails to provide requested updated financial information;²⁶ (d) the IRS determines that the taxpayer provided incorrect information prior to the IA;²⁷ (e) the IRS believes collection is in jeopardy;²⁸ or, (f) the IRS determines that the taxpayer's financial position has changed.²⁹ It is much more difficult for a taxpayer to change the terms of the IA if his financial position deteriorates subsequent to the IA.

The IRS MUST enter into an installment agreement if certain criteria are met. Those criteria include: (a) the liability is not more than \$10,000; (b) the taxpayer has filed all returns in the past 5 years; (c) the taxpayer has either paid all taxes due in the last five years on time, or was in an IA; (d) the IRS determines the taxpayer can't pay in full; (e) the taxpayer can full pay within 3 years; and, (f) the taxpayer agrees to be in compliance during the 3 years.³⁰ If the IRS intends to terminate or alter an IA, they must provide the taxpayer 30 days written notice, unless a jeopardy exists.³¹ Failure to provide notice might be subject to IRC Section 7433 damages.³²

If a taxpayer has some ability to pay, but cannot full pay within the statute of limitations,³³ the IRS can grant a Partial Pay IA (PPIA).³⁴ Normally, the IRS will want whatever equity in available assets of the taxpayer as payment toward the liability.³⁵ In some cases, the taxpayer may keep this equity in assets. Those cases include: if there is minimal equity and no loan potential; if the property is tenants by the entirety and the spouse won't consent to a loan or sale; the asset is unmarketable; the assets will generate future income for the PPIA; economic hardship; or, any loan payment would exceed the taxpayer's disposable income and they wouldn't qualify for a loan.³⁶ To qualify for a PPIA, the taxpayer must make a good faith effort to obtain financing and be unsuccessful.³⁷

Prior to entering into an IA, the IRS makes a determination as to the monthly amount that the taxpayer can afford to pay. To compute this monthly amount, the taxpayer's financial information is submitted to the IRS with either Form 433F, 433A, and/or 433B. In some instances, this information can be provided by telephone and facsimile. The taxpayer's gross income and actual expenses are computed. Then, based on the gross income and number of dependents, the IRS allowable expenses are computed using the IRS National Standard Expenses (NSE) for food, clothing, misc., the Local Standard Expenses (LSE) for housing, and the allowable transportation expenses. Other actual allowable expenses include court ordered payments, taxes, insurance, etc. Although the IRS is supposed to use the NSE and LSE as a guide rather than as an absolute, there are few instances that actual expenses in excess of the IRS allowable standards are allowed. The monthly payment amount is the difference between the gross income and the allowable necessary expenses.

In certain circumstances, a taxpayer may qualify for a "Streamlined" IA, which expedites the processing of the IA. The Streamlined IA skips the requirements for financial analysis and

managerial approval.³⁸ To qualify for such an IA, the following criteria must be met: the balance of the assessed amounts (not including accruals) must be \$25,000 or less; the amount must be paid in full within 5 years, or prior to the statute of limitations, whichever is earlier; and the taxpayer must be in full filing compliance prior to the IA.³⁹

The benefits and/or consequences of entering into an IA are: the taxpayer keeps his assets; the taxpayer pays the tax in full over time (except for the partial pay IA); the IRS will not pursue enforced collection;⁴⁰ the statute of limitations on collection is not extended during the time the IA is in effect;⁴¹ the SOL is extended during the time the IA is “pending” (from the time the taxpayer formally requests an IA until it is accepted);⁴² and, a federal tax lien will probably be filed unless there is justification to forego a lien.⁴³ The most prominent disadvantages facing a taxpayer with respect to an IA are: the taxpayer must live on a small budget during the term of the IA; interest and penalties continue to accrue; and, the taxpayer must stay in compliance or default and face enforced collection.

C. RELEVANT BANKRUPTCY TAX ISSUES:

The 2005 Act was a major overhaul for the bankruptcy code. The provisions that most radically affect any decision with respect to resolving unpaid taxes include the disappearance of the super discharge in Chapter 13,⁴⁴ and the non-dischargeability of fraudulent returns and taxes involving evasion under Chapter 11.⁴⁵ In addition, the post-bankruptcy income of the debtor is an asset of the Chapter 11 estate which he must commit to the plan for up to 5 years, similar to Chapter 13 debtors.⁴⁶ With respect to Chapter 7, a debtor may have to meet the eligibility requirements under the mean/abuse testing criteria. Thus, if a debtor’s income is greater than the state median, and his debt is primarily consumer debt (not tax debt), he may be dismissed or be required to convert to a Chapter 13 or Chapter 11 to stay in bankruptcy.⁴⁷ Finally, the time periods for determining dischargeability of taxes are now tolled anytime the IRS is prohibited from collecting as a result of a request for a hearing and appeal of a collection action.⁴⁸ In short, it is more difficult to qualify for Chapter 7, taxes are not as easily dischargeable in Chapter 13 and Chapter 11 as they were, and the dischargeability periods for taxes are not as easily computed as they were prior to the 2005 Act.

D. CONCLUSION:

Each taxpayer’s situation must be thoroughly analyzed, using IRS literal transcripts of account to make a preliminary determination with respect to the most appropriate of these collection alternatives. The interplay between the Internal Revenue Code and the Bankruptcy Code make such an analysis essential prior to any Installment Agreement, Offer in Compromise, or bankruptcy. Clearly, if the taxes are dischargeable and the taxpayer passes the means test, bankruptcy still provides the most certainty with respect to time frame, consequences, procedural burden, and outcome.

1.I.R.M. 5.8.1.1.1(1).

2.I.R.M. 5.8.1.1.4.

3.I.R.C. Section 7122(c)(3)(B).

4.I.R.M. 5.8.11.2; I.R.M. 5.8.1-1.

5.I.R.M. 5.8.11.2; I.R.M. 5.8.1-1.

6.Form 656.

7.I.R.C. Section 7122(c)(3)(B)(i).

8.I.R.M. 5.8.1.2; I.R.M. 5.8.1.7.3.

9.The Service has added another “asset” to this ability to pay which includes any assets that the Service has deemed the taxpayer “dissipated”. Which could make the amount required for the OIC to include assets the taxpayer no longer owns or to which he has access.

10. I.R.M. 5.8.5; I.R.M.5.8.1.1.3(3); 5/8/1-1; Form 656.

11.Form 656.

12.26 C.F.R. Part 300 (11/1/03).

13. Form 656; 26 C.F.R. Part 300 (11/1/03).

14.I.R.M.5.8.11.2.

15.Public policy is only supposed to be used to reject an OIC if acceptance is detrimental to the interest of the IRS, even though the amount offered is greater than the collectible amount. However, it is not to be used merely because public interest might be generated or the taxpayer was criminally prosecuted. I.R.M. 5.8.7.6.1.

16.I.R.C. Section 7122(c)(1)(A).

17.I.R.C. Section 7122(c)(1)(B).

18.I.R.C. Section 7122(f).

19. 26 CFR 301.6159-1(a).

20.IRC Section 6159(a); IRM Section 5.14.1.7.

21. IRC Section 6159(b)(4)(a)(B).
22. IRC Section 6159(b)(4)(a)(C).
23. Reg. Section 300.1(b).
24. IRC Section 6159(b)(4)(a)(A).
25. IRC Section 6159(b)(4)(a)(B).
26. IRC Section 6159(b)(4)(a)(C).
27. IRC Section 6159(b)(2)(A).
28. IRC Section 6159(b)(2)(B).
29. IRC Section 6159(b)(3).
30. IRC Section 6159(c).
31. IRC Section 6159(b)(5)(A).
32. Grant v. United States, 92 AFTR 2d (RIA) 5600 (S.D. Fla. 2003).
33. The IRS has 10 years to collect the tax from the date of assessment, absent certain events that might extend the 10 years. I.R.C. Section 6502(a)(1).
34. I.R.M. 5.14.2.2.
35. I.R.M. 5.14.2.2(2).
36. I.R.M. 5.14.2.2.2(2).
37. I.R.M. 5.14.2.2.2(3).
38. I.R.M. 5.14.5.1.
39. I.R.M. 5.14.5.2(1).
40. IRC Section 6331(k)(2).
41. IRC Section 6331(k)(2) and (3).
42. IRC Section 6331(k)(2) and (3).
43. IRC Section 6323(j).

44. Taxes which are no longer discharged in a Chapter 13 are: trust fund taxes, 11 U.S.C. Section 507(a)(8)(c); unfiled returns, 11 U.S.C. Section 523(a)(1)(B); late filed returns within 2 years of bankruptcy, 11 U.S.C. Section 523(a)(1)(B); fraudulent returns, 11 U.S.C. Section 523(a)(1)(C); evaded taxes, 11 U.S.C. Section 523(a)(1)(C).

45. 11 U.S.C. Section 1141(d)(6)(B).

46. 11 U.S.C. Section 1115 and 1129.

47. 11 U.S.C. Section 707(b).

48. 11 U.S.C. Section 507(a)(8).