May 30, 2008

Senator Max Baucus	Congressman Charles Rangel
Senator Charles Grassley	Congressman James McCrery
Finance Committee	Committee on Ways and Means
United State Senate	House of Representatives
Washington, D.C. 20510	Washington, D.C. 20515

Dear Chairman Baucus, Chairman Rangel, Ranking Member Grassley and Ranking Member McCrery:

We, the undersigned civil rights, labor and consumer and community groups, write to ask you to remedy the still serious tax problem facing America's homeowners when their mortgages are modified, or even if they are foreclosed upon.

Homeowners Still Need Protection From Tax Consequences of Loan Modification

Congress passed the Mortgage Forgiveness Debt Relief Act of 2007 in December to shelter homeowners in the foreclosure crisis from tax surprises that can jeopardize a family's financial security as much as the debt before it was reduced. Currently, the IRS generally treats forgiven mortgage debt, whether after a foreclosure, short sale, voluntary modification or settlement of litigation, as taxable income. The 2007 Act excludes from taxable income most forgiven primary residence *purchase money* debt. This protects homeowners whose mortgage debt was incurred exclusively to *purchase or substantially improve* their home from tax consequences.

The problem is that the 2007 Act does not provide protection from the sometimes crippling tax consequences that can result from the modification of a mortgage which includes debt consolidation loans, or anything unrelated to the purchase or improvement of the home. Yet a significant portion of the subprime mortgages that now threaten families nationwide were refinancings that paid off non-home loan debt, including medical debt or other health costs, or education loans.[1]

Many of the mortgages headed to foreclosure are adjustable and require new payments which are simply unaffordable to the homeowners. Many other troubled mortgages exceed the value of the homes securing them. Often the only remedy that will work to avoid foreclosure is a reduction of the principal of the mortgage loan – a resolution that Federal Reserve Board Chairman Bernanke has encouraged. *Yet, under current tax law, every dollar of reduced principal – other than what was used to purchase or substantially improve the home – is treated as taxable income to the homeowner.*

Example: Mrs. S and her husband purchased a home for $150,000 in 1999, with a mortgage of $120,000.

In 2002, after an extended illness, Mr. S died, leaving Ms. S to raise their three children herself, as well as pay off tens of thousands of dollars in medical debt.

In 2005, an appraisal for a subprime lender set an inflated value on their home of $240,000 and the lender provided a 3/27 mortgage for $210,000, over $10,000 of which are points and fees.

In 2008, the mortgage payments, which initially were expensive but affordable, now climb to more than 60% of Ms. S's income. The new appraisal on the home shows it is only worth $190,000.

To protect the investor, and avoid a foreclosure, the servicer agrees to reduce the mortgage to $190,000. This provides a forgiveness of mortgage debt of $20,000.

The result – even with the 2007 law – is that all $20,000 of the loan write-down is treated as taxable income in the year of the loan modification.

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[1] Medical debt alone is often the prime impetus for financial disaster for the middle class. According to a recent Harvard University study of the primary causes for bankruptcy, *over half* indicated the bankruptcy was triggered by either medical debt or illness. Further, over 75% of the medically bankrupt had health insurance. *See*, Elizabeth Warren, *Sick and Broke,* Washington Post, February 9, 2005, A29. http://www.washingtonpost.com/wp-dyn/articles/A9447-2005Feb8.html.

Even more troubling is the fact that the same problem exists for the family that loses its home to foreclosure. *All debt that is not paid, is considered forgiven and thus taxable***.**

Attached are two simple amendments to remedy this problem. They are intended to merely extend the protections provided in the 2007 tax law change to all homeowners dealing with the current crisis. **These changes should have very small fiscal consequences because the forgiven debt is still used to reduce the tax basis on the home and when the home is sold any profit is recaptured in the capital gains analysis.** As the basis for the home – which is the original cost, plus the cost of substantial improvements – would be reduced by the amount of forgiven debt, the capital gains upon sale would be increased by the amount of the debt forgiven.

We very much appreciate your support of an amendment to the Internal Revenue Code which will complete the goals of the Mortgage Forgiveness Debt Relief Act of 2007. These changes are an essential part of the effort to save homes and prevent foreclosures.

Please address questions to Margot Saunders of the National Consumer Law Center, 202 452-6252, extension 104, margot@nclcdc.org.

Sincerely,
ACORN
American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)
Center for Responsible Lending
Consumer Action
Consumer Federation of America
Consumers Union
Lawyers Committee for Civil Rights
National Association for the Advancement of Colored People (NAACP)
National Association of Consumer Bankruptcy Attorneys
National Association of Consumer Advocates
National Association of Neighborhoods
National Community Reinvestment Coalition
National Consumer Law Center
National Council of La Raza (NCLR)
National Fair Housing Alliance

Community Legal Services of Philadelphia, Pennsylvania
Connecticut Fair Housing Center
Cuyahoga County (Ohio) Foreclosure Prevention Program
Commonwealth Housing Development Corporation of Pennsylvania
Empire Justice Center of New York
Financial Protection Law Center of North Carolina
Housing Research & Advocacy Center of Cleveland, Ohio
Jacksonville (Florida) Area Legal Aid
Legal Aid Society of Roanoke Valley (Virginia)
Legal Assistance Resource Center of Connecticut
Mountain State Justice of West Virginia
National Council of La Raza
New Haven (Connecticut) Legal Assistance Association
North Carolina Justice Center
South Carolina Appleseed
Virginia Poverty Law Center

Proposed Language to Address Severe Tax Problem Resulting from Mortgage Modification

The following two amendments would change the 2007 language in the Tax Code to allow the benefits to apply to all reductions of principle for mortgage debt on the principal residence of the taxpayer (up to the current statutory cap of $2,000,000).

1. Amend 26 U.S.C. §108(h) --
1) in subsection (2) by rewriting it as follows:

"2) Qualified principal residence indebtedness.--For purposes of this section, the term "qualified principal residence indebtedness" means ~~acquisition indebtedness (within the meaning of section 163(h)(3)(B)~~, indebtedness, applied by substituting "$2,000,000 ($1,000,000" for "$1,000,000 ($500,000" in clause (ii) thereof) with respect to the principal residence of the taxpayer."

2) delete subsection (h)(4).

Explanation: This simply deletes from the 2007 law the limitation of the application of the law to debt used to purchase or substantially improve the taxpayer's residence. With this change, taxpayers in 2007, 2008 and 2009, whose mortgage debt on their principle residence is forgiven because of either a decline in the value of the property or the financial condition of the taxpayer (§108(h)(3)), will *not* have the forgiven debt treated as taxable income.

As in the 2007 law, the effect of this provision would *only postpone the taxable consequences, because the forgiven debt would be subtracted from the basis, and the effect of the forgiven debt would be counted when the home is sold.* Subsection (h)(4) was an ordering rule to deal with situations where a mortgage included both acquisition debt and other types of debt; with this new language the ordering rule is no longer necessary.

2. Amend 26 USC 6050P --
In subsection (b) by making the current language a subparagraph "1)" and by adding a semicolon at the end of the existing language, and the following:

"or 2) indebtedness secured by the taxpayer's principal residence, within the meaning of section 121."

Explanation: As this forgiveness of debt is not immediately taxable, this would relieve the creditor who has forgiven the debt from reporting that to the IRS.

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