

Application of Section 108(a)(1)(E)(ii) to the Federal Housing Finance Agency's (FHFA's) Principal Reduction Modification Program (PRMP) and the Home Affordable Modification Program®(HAMP®)

Notice 2016-72

## **PURPOSE**

This notice provides guidance on whether qualified principal residence indebtedness is discharged “subject to an arrangement that is entered into and evidenced in writing before January 1, 2017” within the meaning of § 108(a)(1)(E)(ii) of the Internal Revenue Code if, before that date, a mortgage loan servicer sends a borrower-homeowner under the Federal Housing Finance Agency's (FHFA's) Principal Reduction Modification Program (PRMP) a notice in conjunction with a written Trial Period Plan (TPP) or, for a borrower-homeowner in an active TPP, a separate notice in a written opt-out letter outlining the terms and conditions of the permanent mortgage loan modification following completion of the active TPP.

This guidance also applies to a TPP under the Home Affordable Modification Program® (HAMP®).

## **BACKGROUND**

To help distressed borrower-homeowners lower their monthly mortgage payments, FHFA directed the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) to implement the PRMP, which offers mortgage loan modifications to certain seriously delinquent, underwater

borrower-homeowners who are still struggling in the aftermath of the financial crisis, to help them avoid foreclosure and stay in their homes. The PRMP is a targeted, one-time offering for borrower-homeowners whose loans are owned or guaranteed by Fannie Mae or Freddie Mac and who meet specific eligibility criteria.

For a borrower-homeowner to take advantage of the PRMP, the mortgage loan servicer must solicit the borrower-homeowner's participation by sending the borrower-homeowner a notice of PRMP eligibility in conjunction with a written TPP or, for a borrower-homeowner in an active TPP, a separate notice of PRMP eligibility in a written opt-out letter. The TPP and the PRMP notice set forth Trial Period and PRMP Conditions that the borrower-homeowner must satisfy for there to be a permanent modification of the mortgage loan. In the case of an active TPP, the notice in the written opt-out letter outlines the terms and conditions of the principal reduction feature of the loan modification. If the Trial Period and PRMP Conditions are satisfied within a required time frame, then the borrower-homeowner is offered a permanent modification of the terms of the mortgage loan. If the borrower-homeowner executes and returns the loan modification agreement, the mortgage loan is thereby modified. The modification includes monthly mortgage payments that are lower than or equal to those under the old mortgage loan and, generally, a principal reduction.

HAMP®, currently available through the end of 2016, offers a similar program to help distressed borrower-homeowners lower their monthly mortgage payments. See Rev. Proc. 2013-16, 2013-7 I.R.B. 488, which discusses the federal tax consequences of principal reduction of a mortgage loan under the HAMP® Principal Reduction Alternative<sup>SM</sup>.

## **APPLICABLE PROVISIONS OF LAW AND ANALYSIS**

Under § 61, except as otherwise provided in subtitle A, gross income means all income from whatever source derived, including income from discharge of indebtedness. See § 61(a)(12).

Under § 108(a)(1)(E), gross income does not include any amount that (but for § 108(a)) would be includible in gross income by reason of the discharge (in whole or in part) of a taxpayer's indebtedness if the indebtedness discharged is qualified principal residence indebtedness that is discharged (i) before January 1, 2017, or (ii) subject to an arrangement that is entered into and evidenced in writing before January 1, 2017.

Under §§ 108(h)(2) and 163(h)(3)(B), qualified principal residence indebtedness is any indebtedness that is incurred by a borrower to buy, build, or substantially improve the borrower's principal residence and is secured by that residence.

Qualified principal residence indebtedness also includes a loan secured by the borrower's principal residence that refinances qualified principal residence indebtedness, but only to the extent of the amount of the refinanced indebtedness. See §§ 108(h)(2) and 163(h)(3)(B)(i).

The maximum amount of discharged indebtedness that a borrower may exclude from gross income under the qualified principal residence indebtedness exclusion is \$2,000,000 (\$1,000,000 for a married individual filing a separate return). See § 108(h)(2). Under § 108(h)(4), if only part of the discharged indebtedness is qualified principal residence indebtedness, then the exclusion applies only to the amount of the discharged indebtedness that exceeds the amount of the loan (determined immediately before the discharge) that is not qualified principal residence indebtedness.

If an amount is excluded from gross income as a discharge of qualified principal residence indebtedness, the taxpayer must reduce the basis of the taxpayer's principal residence. See § 108(h)(1).

Congress extended the relief under § 108(a)(1)(E) to arrangements entered into and evidenced in writing before January 1, 2017, in the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, 129 Stat 2242, 3065-66 (2015) (PATH Act). Congress added this provision to protect a borrower-homeowner who is in the process of obtaining a permanent modification of the mortgage loan during 2016, although the permanent modification of the mortgage loan resulting in discharge of indebtedness would not occur until after 2016. For example, a borrower-homeowner who is in the process of obtaining a modified mortgage loan under the PRMP during 2016, because the borrower-homeowner is either in an active TPP or the mortgage loan servicer sends the borrower-homeowner a notice in conjunction with a TPP, might not complete the modification process until after 2016. The addition of § 108(a)(1)(E)(ii) by the PATH Act is designed to ensure that discharges of qualified principal residence indebtedness in these situations qualify for exclusion from income under that section.

A discharge of indebtedness that does not qualify for the qualified principal residence indebtedness exclusion in § 108(a)(1)(E) may qualify for another exclusion, such as the insolvency exclusion under § 108(a)(1)(B) or the deductible debt exclusion under § 108(e)(2). For example, a cash basis homeowner generally would exclude from income under § 108(e)(2) the discharge of any accrued but unpaid interest on the mortgage for his or her principal residence to the extent the interest would have been deductible if paid. See *Johnson v. Commissioner*, T.C. Memo 1999-162, and *Lawinger*

*v. Commissioner*, 103 T.C. 428 (1994). For more information about income from discharge of indebtedness, the qualified principal residence indebtedness exclusion, the insolvency exclusion, the deductible debt exclusion, and other exclusions from gross income that may apply, see Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

## **FEDERAL INCOME TAX CONSEQUENCE**

Qualified principal residence indebtedness is discharged “subject to an arrangement that is entered into and evidenced in writing before January 1, 2017” within the meaning of § 108(a)(1)(E)(ii) if: (1) before that date, a mortgage servicer sends a borrower-homeowner under the FHFA’s PRMP a notice in conjunction with a written TPP or, for a borrower-homeowner in an active TPP, a separate notice in a written opt-out letter outlining the terms and conditions of the permanent mortgage loan modification following completion of the active TPP; (2) the borrower-homeowner satisfies all of the Trial Period and PRMP Conditions; and (3) the borrower-homeowner and servicer enter into a permanent modification of the mortgage loan on or after January 1, 2017. A similar conclusion applies to a TPP under HAMP®.

## **DRAFTING INFORMATION**

The principal author of this notice is Sheldon Iskow of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information about this notice, contact Mr. Iskow at (202) 317-4718 (not a toll free call).