BANKRUPTCY
NORTHERN DISTRICT OF TEXAS
BANKRUPTCY BENCH/BAR CONFERENCE:

IRS & HOME LOAN MODIFICATIONS

MATERIAL PROVIDED BY LEO CAREY, BANKRUPTCY SPECIALIST FOR IRS

1.) Form 982: Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment);

2.) Part 1: Section 61 – Gross Income Defined;

3.) Principal Reduction Alternative Under the Home Affordable Modification Program;

4.) Form 14134: Application for Certificate of Subordination of Federal Tax Lien;

5.) Section 121 – Exclusion of Gain from Sale of Principal Residence;

6.) Special Information Relating to Purchase Money Mortgages, Purchase Money Security Interest, and Subordination of the Federal Tax Lien; and,

7.) IRS Announces Guidance on the Principal Reduction Alterative Offered in the Home Affordable Modification Program (HAMP).

Form **982**
(Rev. January 2016)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ Attach this form to your income tax return.
▶ Information about Form 982 and its instructions is at *www.irs.gov/form982*.

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return | Identifying number

Part I General Information (see instructions)

1 Amount excluded is due to (check applicable box(es)):
a Discharge of indebtedness in a title 11 case . . . ☐
b Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . ☐
c Discharge of qualified farm indebtedness . . . ☐
d Discharge of qualified real property business indebtedness . . . ☐
e Discharge of qualified principal residence indebtedness . . . ☐
2 Total amount of discharged indebtedness excluded from gross income . . . 2
3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? . . . ☐ Yes ☐ No

Part II Reduction of Tax Attributes.

You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9	Applied to reduce any net capital loss for the tax year of the discharge, including any capital loss carryovers to the tax year of the discharge	9	
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	10a	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	10b	
11	For a discharge of qualified farm indebtedness applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business or for the production of income if not reduced on line 5	11a	
b	Land used or held for use in a trade or business of farming	11b	
c	Other property used or held for use in a trade or business or for the production of income	11c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13	

Part III Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)

Under section 1081(b), the corporation named above has excluded $ _____ from its gross income for the tax year beginning _____ and ending _____.
Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of _____.
(State of incorporation)

Note: You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Future developments. For the latest information about developments related to Form 982 and its instructions, such as legislation enacted after they were published, go to *www.irs.gov/form982*.

Purpose of Form

Generally, the amount by which you benefit from the discharge of indebtedness is included in your gross income. However, under certain circumstances described in section 108, you can exclude the amount of discharged indebtedness from your gross income.

You must file Form 982 to report the exclusion and the reduction of certain tax attributes either dollar for dollar or 33 1/3 cents per dollar (as explained below).

How To Complete the Form

IF the discharged debt you are excluding is . . .	THEN follow these steps . . .
Qualified principal residence indebtedness	**1.** Be sure to read the definition of qualified principal residence indebtedness in the instructions for line 1e on page 4. Part or all of your debt may not qualify for the exclusion on line 1e but may qualify for one of the other exclusions. **2.** Check the box on line 1e. **3.** Include on line 2 the amount of discharged qualified principal residence indebtedness that is excluded from gross income. Any amount in excess of the excluded amount may result in taxable income. See Pub. 4681 for more information. If you disposed of your residence, you may also be required to recognize a gain on its disposition. For details, see Pub. 523, Selling Your Home. **4.** If you continue to own your residence after the discharge, enter on line 10b the smaller of (a) the amount of qualified principal residence indebtedness included on line 2 or (b) the basis (generally, your cost plus improvements) of your principal residence. **CAUTION** *If the discharge occurs in a title 11 case, you can't check box 1e. You must check box 1a and complete the form as discussed below under* A nonbusiness debt. *If you are insolvent (and not in a title 11 case), you can elect to follow the insolvency rules by checking box 1b instead of box 1e and completing the form as discussed below under* A nonbusiness debt.
A nonbusiness debt (other than qualified principal residence indebtedness, such as a car loan or credit card debt)	Follow these instructions if you don't have any of the tax attributes listed in Part II (other than a basis in nondepreciable property). Otherwise, follow the instructions for *Any other debt* below. **1.** Check the box on line 1a if the discharge was made in a *title 11 case* (see *Definitions*, later) or the box on line 1b if the discharge occurred when you were *insolvent* (see *Line 1b*, later). **2.** Include on line 2 the amount of discharged nonbusiness debt that is excluded from gross income. If you were insolvent, don't include more than the excess of your liabilities over the fair market value of your assets. **3.** Include on line 10a the smallest of (a) the basis of your nondepreciable property, (b) the amount of the nonbusiness debt included on line 2, or (c) the excess of the aggregate bases of the property and the amount of money you held immediately after the discharge over your aggregate liabilities immediately after the discharge.
Any other debt	Use *Part I* of Form 982 to indicate why any amount received from the discharge of indebtedness should be excluded from gross income and the amount excluded. Use *Part II* to report your reduction of tax attributes. The reduction must be made in the following order unless you check the box on line 1d for qualified real property business indebtedness or make the election on line 5 to reduce basis of depreciable property first. **1.** Any net operating loss (NOL) for the tax year of the discharge (and any NOL carryover to that year) (dollar for dollar); **2.** Any general business credit carryover to or from the tax year of the discharge (33 1/3 cents per dollar); **3.** Any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge (33 1/3 cents per dollar); **4.** Any net capital loss for the tax year of the discharge (and any capital loss carryover to that tax year) (dollar for dollar); **5.** The basis of property (dollar for dollar); **6.** Any passive activity loss (dollar for dollar) and credit (33 1/3 cents per dollar) carryovers from the tax year of the discharge; and **7.** Any foreign tax credit carryover to or from the tax year of the discharge (33 1/3 cents per dollar). Use *Part III* to exclude from gross income under section 1081(b) any amounts of income attributable to the transfer of property described in that section.

Certain individuals may need to complete only a few lines on Form 982. For example, if you are completing this form because of a discharge of indebtedness on a personal loan (such as a car loan or credit card debt) or a loan for the purchase of your principal residence, follow the chart, earlier, to see which lines you need to complete. Also, see Pub. 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments, for additional information.

Definitions

Title 11 Case

A *title 11 case* is a case under title 11 of the United States Code (relating to bankruptcy), but only if you are under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is under a plan approved by the court.

Discharge of Indebtedness

The term *discharge of indebtedness* conveys forgiveness of, or release from, an obligation to repay.

When To File

File Form 982 with your federal income tax return for a year a discharge of indebtedness is excluded from your income under section 108(a).

The election to reduce the basis of depreciable property under section 108(b)(5) and the election made on line 1d of Part I regarding the discharge of qualified real property business indebtedness must be made on a timely filed return (including extensions) and can be revoked only with the consent of the IRS.

If you timely filed your tax return without making either of these elections, you can still make either election by filing an amended return within 6 months of the due date of the return (excluding extensions). Write "Filed pursuant to section 301.9100-2" on the amended return and file it at the same place you filed the original return.

Specific Instructions

Part I

The time for making a section 108(i) election has passed. If you made an election under section 108(i) to defer income from the discharge of business debt arising from the reacquisition of a debt instrument in 2009 or 2010, don't report the amount deferred under the election in lines 1a through 1d and line 2.

Line 1b

The insolvency exclusion doesn't apply to any discharge that occurs in a title 11 case. It also doesn't apply to a discharge of qualified principal residence indebtedness (see the instructions for line 1e on page 4) unless you elect to have the insolvency exclusion apply instead of the exclusion for qualified principal residence indebtedness.

Check the box on line 1b if the discharge of indebtedness occurred while you were insolvent. You were insolvent to the extent that your liabilities exceeded the fair market value (FMV) of your assets immediately before the discharge. For details and a worksheet to help calculate insolvency, see Pub. 4681.

Example. You were released from your obligation to pay your credit card debt in the amount of $5,000. The FMV of your total assets immediately before the discharge was $7,000 and your liabilities were $10,000. You were insolvent to the extent of $3,000 ($10,000 of total liabilities minus $7,000 of total assets). Check the box on line 1b and include $3,000 on line 2.

Line 1c

Check this box if the income you exclude is from the discharge of qualified farm indebtedness. The exclusion relating to qualified farm indebtedness doesn't apply to a discharge that occurs in a title 11 case or to the extent you were insolvent.

Qualified farm indebtedness is the amount of indebtedness incurred directly in connection with the trade or business of farming. In addition, 50% or more of your aggregate gross receipts for the three tax years preceding the tax year in which the discharge of such indebtedness occurs must be from the trade or business of farming. For more information, see sections 108(g) and 1017(b)(4).

The discharge must have been made by a qualified person. Generally, a *qualified person* is an individual, organization, etc., who is actively and regularly engaged in the business of lending money. This person can't be related to you, be the person from whom you acquired the property, or be a person who receives a fee with respect to your investment in the property. A qualified person also includes any federal, state, or local government or agency or instrumentality thereof.

If you checked line 1c and didn't make the election on line 5, the debt discharge amount will be applied to reduce the tax attributes in the order listed on lines 6 through 9. Any remaining amount will be applied to reduce the tax attributes in the order listed on lines 11a through 13.

You can't exclude more than the total of your (a) tax attributes (determined under section 108(g)(3)(B)) and (b) basis of property used or held for use in a trade or business or for the production of income. Any excess is included in income.

Line 1d

If you check this box, the discharge of qualified real property business indebtedness is applied to reduce the basis of depreciable real property on line 4. The exclusion relating to qualified real property business indebtedness doesn't apply to a discharge that occurs in a title 11 case or to the extent you were insolvent.

Qualified real property business indebtedness is indebtedness (other than qualified farm indebtedness) that (a) is incurred or assumed in connection with real property used in a trade or business, (b) is secured by that real property, and (c) with respect to which you have made an election under this provision. This provision doesn't apply to a corporation (other than an S corporation).

Indebtedness incurred or assumed after 1992 isn't qualified real property business indebtedness unless it is either (a) debt incurred to refinance qualified real property business indebtedness incurred or assumed before 1993 (but only to the extent the amount of such debt doesn't exceed the amount of debt being refinanced) or (b) qualified acquisition indebtedness.

Qualified acquisition indebtedness is (a) debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property that is secured by such debt and (b) debt resulting from the refinancing of qualified acquisition indebtedness to the extent the amount of such debt doesn't exceed the amount of debt being refinanced.

You can't exclude more than the excess of the outstanding principal amount of the debt (immediately before the discharge) over the net FMV (as of that time) of the property securing the debt reduced by the outstanding principal amount of other qualified real property business indebtedness secured by that property (as of that time). The amount excluded is further limited to the aggregate adjusted basis (as of the first day of the next tax year or, if earlier, the date of disposition) of depreciable real property (determined after any reductions under sections 108(b) and (g)) you held immediately before the discharge (other than property acquired in contemplation of the discharge). Any excess is included in income.

Line 1e

Check this box if the income you exclude is from discharge of qualified principal residence indebtedness. Also, be sure you complete line 2 (and line 10b if you continue to own the residence after discharge). However, if the discharge occurs in a title 11 case, you must check the box on line 1a and not this box. If you are insolvent (and not in a title 11 case), you can elect to follow the insolvency rules by checking box 1b instead of checking this box. For more information, see Pub. 4681.

Principal residence. Your principal residence is your *main home*, which is the home where you ordinarily live most of the time. You can have only one main home at any one time.

Qualified principal residence indebtedness. This indebtedness is a mortgage you took out to buy, build, or substantially improve your main home. It also must be secured by your main home. If the amount of your original mortgage is more than the cost of your main home plus the cost of any substantial improvements, only the debt that is **not** more than the cost of your main home plus improvements is qualified principal residence indebtedness. Any debt secured by your main home that you use to refinance qualified principal residence indebtedness is treated as qualified principal residence indebtedness, but only up to the amount of the old mortgage principal just before the refinancing. Any additional debt you incurred to substantially improve your main home is also treated as qualified principal residence indebtedness.

Amount eligible for the exclusion. The exclusion applies only to debt discharged after 2006. The maximum amount you can treat as qualified principal residence indebtedness is $2 million ($1 million if married filing separately). You can't exclude from gross income discharge of qualified principal residence indebtedness if the discharge was for services performed for the lender or on account of any other factor not directly related to a decline in the value of your residence or to your financial condition.

Ordering rule. If only a part of a loan is qualified principal residence indebtedness, the exclusion applies only to the extent the amount discharged exceeds the amount of the loan (immediately before the discharge) that is **not** qualified principal residence indebtedness. For example, assume your main home is secured by a debt of $1 million, of which $800,000 is qualified principal residence indebtedness. If your main home is sold for $700,000 and $300,000 of debt is discharged, only $100,000 of the debt discharged can be excluded (the $300,000 that was discharged minus the $200,000 of nonqualified debt). The remaining $200,000 of nonqualified debt may qualify in whole or in part for one of the other exclusions, such as the insolvency exclusion.

Line 2

Enter the total amount excluded from your gross income due to discharge of indebtedness under section 108. If you checked any box on lines 1b through 1e, don't enter more than the limit explained in the instructions for those lines. If you checked line 1a, 1b, or 1c, this amount won't necessarily equal the total reductions on lines 5 through 13 (excluding line 10b) because the debt discharge amount may exceed the total tax attributes. If you checked line 1e, this amount won't necessarily equal the total basis reduction on line 10b (which is required only if you continue to own the residence after the discharge).

See section 382(l)(5) for a special rule regarding a reduction of a corporation's tax attributes after certain ownership changes.

Line 3

You can elect under section 1017(b)(3)(E) to treat all real property held primarily for sale to customers in the ordinary course of a trade or business as if it were depreciable property. This election doesn't apply to the discharge of qualified real property business indebtedness. To make the election, check the "Yes" box.

Part II

Basis Reduction

If you check any of the boxes on lines 1a through 1c, you can elect, by completing line 5, to apply all or a part of the debt discharge amount to first reduce the basis of depreciable property (including property you elected on line 3 to treat as depreciable property). Any balance of the debt discharge amount will then be applied to reduce the tax attributes in the order listed on lines 6 through 13 (excluding line 10b). You must attach a statement describing the transactions that resulted in the reduction in basis under section 1017 and identifying the property for which you reduced the basis. If you don't make the election on line 5, complete lines 6 through 13 (excluding line 10b) to reduce your attributes. See section 1017(b)(2) and (c) for limitations of reductions in basis on line 10a.

Line 7

If you have a general business credit carryover to or from the tax year of the discharge, you must reduce that carryover by 33⅓ cents for each dollar excluded from gross income. See Form 3800, General Business Credit, for more details on the general business credit, including rules for figuring any carryforward or carryback.

Line 10a

In the case of a title 11 case or insolvency, the reduction in basis is limited to the aggregate of the basis of your property immediately after the discharge over the aggregate of your liabilities immediately after the discharge. However, this limit doesn't apply to a reduction in basis reported on line 5 pursuant to section 108(b)(5).

Line 10b

If box 1e is checked and you continue to own the residence after discharge, enter the smaller of:

- The part of line 2 that is attributable to the exclusion of qualified principal residence indebtedness, or
- The basis of your main home.

Part III

Adjustment to Basis

Unless it specifically states otherwise, the corporation, by filing this form, agrees to apply the general rule for adjusting the basis of property (as described in Regulations section 1.1082-3(b)).

If the corporation desires to have the basis of its property adjusted in a manner different from the general rule, it must attach a request for variation from the general rule. The request must show the precise method used and the allocation of amounts.

Consent to the request for variation from the general rule will be effective only if it is incorporated in a closing agreement entered into by the corporation and the Commissioner of Internal Revenue under the rules of section 7121. If no agreement is entered into, then the general rule will apply in determining the basis of the corporation's property.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You aren't required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown as follows: **Recordkeeping,** 5 hr., 58 min.; **Learning about the law or the form,** 2 hr., 34 min.; **Preparing and sending the form to the IRS,** 2 hr., 48 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

Part 1

Section 61.—Gross income defined

26 C.F.R. 1.61-1(a): Gross income

Rev. Rul. 2009-19

ISSUE

If a homeowner benefits from Pay-for-Performance Success Payments under the United States Government's Home Affordable Modification Program (HAMP), are those payments excludable from income under the general welfare exclusion?

FACTS

The deep contraction in the economy and in the housing market has created stress for homeowners throughout the country. Large numbers of homeowners are struggling to afford their current monthly mortgage payments and are at risk of losing their homes. In response, the United States Government announced the Homeowner Affordability and Stability Plan (the Plan), which helps at-risk homeowners modify their mortgages to avoid foreclosure.

HAMP, a key component of the Plan, helps homeowners who have defaulted, or are at risk of default, on their mortgages because, for example, they are suffering

serious hardships, decreases in income, increases in expenses, and high mortgage debt compared to monthly income.

Under HAMP, homeowners that make timely payments on their modified loans are eligible to have incentive payments made on their behalf to lenders/investors. Each month that a homeowner makes a mortgage payment on time, the homeowner accrues an amount toward a Pay-for-Performance Success Payment. A payment of the accrued amounts is made annually, to reduce the principal balance on the homeowner's mortgage loan. Homeowners can receive principal reductions of up to $1,000 per year for up to five years, subject to a *de minimis* threshold.

The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation have a substantial role in administering HAMP.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Payments under governmental social benefit programs for the promotion of the general welfare and not for services rendered, however, are not includible in a recipient's gross income (general welfare exclusion). *See* Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 98-19, 1998-1 C.B. 840.

Pay-for-Performance Success Payments made under the United States Government's Home Affordable Modification Program promote the general welfare by helping homeowners who are at risk of losing their homes pay the mortgage loans on their primary residences and do not involve the performance of services. These payments meet the requirements of the general welfare exclusion.

HOLDING

If a homeowner benefits from Pay-for-Performance Success Payments under the United States Government's Home Affordable Modification Program, the payments are excludable from income under the general welfare exclusion.

DRAFTING INFORMATION

The principal author of this revenue ruling is Sheldon Iskow of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Iskow at (202) 622-4920 (not a toll-free number).

Principal Reduction Alternative Under the Home Affordable Modification Program

Background

To help distressed homeowners lower their monthly mortgage payments, the U.S. Departments of the Treasury and of Housing and Urban Development established the Home Affordable Modification Program℠ (HAMP℠) for mortgage loans that are not owned or guaranteed by Fannie Mae or Freddie Mac.

Under HAMP, a participating loan servicer must consider a sequence of modification steps for each eligible homeowner's mortgage loan until the loan's monthly payment is reduced to 31 percent of the homeowner's verified monthly gross (pre-tax) income. Sometimes, a change in the mortgage loan's interest rate is sufficient to reach the 31–percent target. Sometimes additional modification steps of term extension or forbearance are necessary as well. See the Home Affordable Modification Program (HAMP) page on the MakingHomeAffordable.gov website.

(For mortgage loans that are owned or guaranteed by Fannie Mae or Freddie Mac, eligible homeowners may be offered modifications under related programs also called "HAMP." Because these related programs do not contain the principal reduction provision that these FAQs address, these FAQs use the term "HAMP" to refer only to the program for mortgage loans that are not owned or guaranteed by Fannie Mae or Freddie Mac.)

Since the last quarter of 2010, if a mortgage loan is being considered for a HAMP modification and if the ratio of the amount owed to the value of the home is greater than 115 percent, then the servicer must consider whether a Principal Reduction Alternative℠ (PRA) principal reduction should be effected as one part of the HAMP modification. See the Principal Reduction Alternative (PRA) page on the MakingHomeAffordable.gov website.

For HAMP modifications that include a PRA principal reduction, the unpaid principal balance of the modified loan is divided into an interest-bearing principal amount and a non-interest-bearing PRA Forbearance Amount. If the homeowner then achieves a payment history that is sufficiently timely over a three-year period, the entire PRA Forbearance Amount is eventually reduced to zero.

In connection with every HAMP modification of a loan that is not owned or guaranteed by Fannie Mae or Freddie Mac, to encourage participation in HAMP, the government provides incentives to the investor (that is, the holder of the loan), to the homeowner, and to the servicer. If a HAMP modification of such a mortgage loan includes a PRA principal reduction, the government makes additional incentive payments over three years to the investor. (These additional incentives are called "PRA investor incentive payments.") The size of the PRA investor incentive payments depends not only on the amount of principal reduced but also on the loan-to-value ratio and the loan's payment history before the HAMP modification. The PRA investor incentive payments range from 6% to 21% of the principal amount reduced.

For information on tax issues related to the Principal Reduction Alternative, see the questions and answers below.

Questions and Answers on Tax Issues Related to the Principal Reduction Alternative

Q1: If the government makes a PRA investor incentive payment to the holder of the mortgage loan, how is that payment analyzed for federal income tax purposes?

A1: The PRA investor incentive payment to the holder is treated as a payment on the loan by the government on behalf of the homeowner.

Q2: Does a homeowner have income as a result of the government's having paid some of the homeowner's mortgage loan by making a PRA investor incentive payment to the holder of the loan?

A2: No. This payment by the government on behalf of the homeowner is excludible from the homeowner's income under the general welfare exclusion. Excluding this amount from the homeowner's gross income is consistent with the treatment of Pay-for-Performance Success Payments, which are addressed in Revenue Ruling 2009–19.

Q3: In a HAMP modification that includes a PRA principal reduction, the holder of the loan reduces the PRA Forbearance Amount by more than the PRA investor incentive payments (which are treated as payments on the loan on behalf of the homeowner). What federal income tax consequences for the homeowner result from that additional reduction by the holder?

A3: To the extent that the reduction in the PRA Forbearance Amount is more than the PRA investor incentive payments, the reduction is from the discharge of indebtedness. The full amount of this discharge of indebtedness is reported to the IRS and the homeowner on Form 1099–C, Cancellation of Debt, regardless of whether the homeowner may exclude any, or all, of it from gross income. See Questions 4 and 5 below for discussion of some exclusions that may apply.

Q4: Does the exclusion for qualified principal residence indebtedness apply to amounts discharged under a PRA principal reduction?

A4: The exclusion for qualified principal residence indebtedness may apply to a discharge of indebtedness under a PRA principal reduction if the amount discharged meets the criteria for qualified principal residence indebtedness. Under current law, this exclusion does not apply to discharges that occur after Dec. 31, 2013. For further discussion of the qualified principal residence exclusion, see the questions and answers on The Mortgage Forgiveness Debt Relief Act and Debt Cancellation page. *(No longer available)*

Q5: Does the insolvency exclusion apply to amounts discharged under a PRA principal reduction?

A5: The insolvency exclusion may apply to a discharge of indebtedness under a PRA principal reduction to the extent that the taxpayer is insolvent when the discharge occurs. For further discussion of the insolvency exclusion, see page 4 of Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals).

Page Last Reviewed or Updated: 13-Oct-2015

Form **14134**
(June 2010)

Department of the Treasury — Internal Revenue Service

Application for Certificate of Subordination of Federal Tax Lien

OMB No. 1545-2174

Complete the entire application. Enter NA *(not applicable)*, when appropriate. Attachments and exhibits should be included as necessary. Additional information may be requested to clarify the details of the transaction*(s)*.

1. Taxpayer Information *(Individual or Business named on the notice of lien)*

Name *(Individual First, Middle Initial, Last)* or *(Business)* as it appears on lien		Primary Social Security Number *(last 4 digits only)*
Name Continuation *(Individual First, Middle Initial, Last)* or *(Business d/b/a)*		Secondary Social Security Number *(last 4 digits only)*
Address *(Number, Street, P.O. Box)*		Employer Identification Number
City	State	ZIP Code
Telephone Number *(with area code)*	Fax Number *(with area code)*	

2. Applicant Information

☐ Check if also the Taxpayer *(If not the taxpayer, attach copy of lien. See Sec.10)*

Name *(First, Middle Initial, Last)*		Relationship to taxpayer
Address *(Number, Street, P.O. Box)*		
City	State	ZIP Code
Telephone Number *(with area code)*	Fax Number *(with area code)*	

3. Property Owner

☐ Check if also the Applicant

	Relationship to Taxpayer

4. Attorney/Representative Information

Attached: Form 8821 or Power of Attorney Form 2848 ☐ Yes ☐ No

Name *(First, Middle Initial, Last)*		Interest Represented *(e.g. taxpayer, lender, etc.)*
Address *(Number, Street, P.O. Box)*		
City	State	ZIP Code
Telephone Number *(with area code)*	Fax Number *(with area code)*	

5. Lending/Finance Company

Company Name	Contact Name	Contact Phone Number
Type of transaction *(For example, loan consolidation, refinance, etc)*		

6. Monetary Information

Amount of existing loan *(if refinancing)*	
Amount of new loan	
Amount to be paid to the United States *(6325(d)(1) applications only)*	

7. Basis for Subordination: Check the box below that best addresses what you would like the United States to consider in your application for subordination. *(Publication 784 has additional descriptions of the Internal Revenue Code sections listed below.)*

☐ 6325(d)(1) the United States will receive an amount equal to the lien or interest to which the certificate of subordination is issued *(provide amount in Section 6 above)*

☐ 6325(d)(2) the issuance of the certificate of subordination will increase the government's interest and make collection of the tax liability easier. ***(Complete and attach a signed and dated statement describing how the amount the United States may ultimately realize will increase and how collection will be facilitated by the subordination.)***

Statement ☐ Attached ☐ NA

8. Description of property *(For example, 3 bedroom rental house; 2002 Cessna twin engine airplane, serial number AT919000000000X00; etc.):*

Address of real property ***(If this is personal property list the address where the property is located)*:**

Address *(Number, Street, P.O. Box)*

City	State	ZIP Code

Real Estate:
Legible copy of deed or title showing legal description ☐ Attached ☐ NA

9. Appraisal and Valuations

Appraisal: (Professional appraisal completed by a disinterested third party but it is not required for a subordination)	☐ Attached
OR ONE OF THE FOLLOWING VALUATIONS:	
County valuation of property *(real property)*	☐ Attached
Informal valuation of property by disinterested third party	☐ Attached
Proposed selling price *(for property being sold at auction)*	☐ Attached
Other:_____	☐ Attached

10. Copy of Federal Tax Lien(s) *(Complete if applicant and taxpayer differ)* ☐ Attached ☐ No

OR list the lien number(s) found near the top right corner on the lien document(s) *(if known)*

11. Copy of the proposed loan agreement *(if available)* ☐ Attached ☐ No

AND

Describe how subordination is in the best interests of the United States:

12. Copy of a current title report *(required for subordination)* ☐ Attached ☐ No

OR

List encumbrances with seniority over the Federal Tax Lien. Include name and address of the holder; description of the encumbrance, e.g., mortgage, state lien, etc.; date of agreement; original loan amount and interest rate; amount due at time of application; and family relationship, if applicable. Include any home equity line of credit (HELOCs) advances beginning the 46th day after the NFTL was filed, through the date you submit your application, and include expected advances through the date the certificate will be issued. ***(Attach additional sheets as needed)***:

13. Copy of proposed closing statement ***(aka HUD-1)*** ☐ Attached ☐ No

OR

Itemize all proposed costs, commissions, and expenses of any transfer or sale associated with property ***(Attach additional sheets as needed):***

14. Additional information that may have a bearing on this request, such as pending litigation, explanations of unusual situations, etc., is attached for consideration ☐ Yes ☐ No

15. Declaration

Under penalties of perjury, I declare that I have examined this application, including any accompanying schedules, exhibits, affidavits, and statements and to the best of my knowledge and belief it is true, correct and complete.

Signature/Title _____ Date _____

Signature/Title _____ Date _____

Section 121.—Exclusion of gain from sale of principal residence

26 CFR 1.121-1: Exclusion of gain from sale or exchange of a principal residence.
(Also: §§ 61, 165, 691, 1001; 1.61-6, 1.165-1, 1.691(a)-1, 1.1001-1.)

Rev. Rul. 2014-2

ISSUES

1. If a taxpayer receives a payment pursuant to the National Mortgage Settlement due to the foreclosure of the taxpayer's principal residence ("NMS Payment"), what is the proper tax characterization of the payment?

2. If the NMS Payment is characterized as part of the amount realized on the foreclosure and if that characterization creates or increases a gain on the foreclosure of the principal residence, are there grounds for the taxpayer to exclude from gross income some or all of that gain?

3. If the property for which a taxpayer receives an NMS Payment contained one or more additional dwelling units that were not used as the taxpayer's principal residence, how should the NMS Payment be allocated between the portion of the property that the taxpayer used as a principal residence and the rest of the property?

4. If a borrower who was eligible for an NMS Payment died before receiving it, what is the tax treatment of the person who receives that payment?

BACKGROUND

In 2012, the United States government and the attorneys general of 49 states and the District of Columbia entered into settlement agreements with five bank mortgage servicers to address mortgage loan servicing and foreclosure abuses ("National Mortgage Settlement").[1] One component of the National Mortgage Settlement is the Borrower Payment Fund (Fund), which the parties intend to be structured as a qualified settlement fund under § 1.468B-1 of the Income Tax Regulations. The terms of the settlement agreements provide that:

(1) The five mortgage servicers collectively will pay approximately $1.5 billion into the Fund.

(2) The Fund will make NMS Payments to certain borrowers who lost their principal residences in foreclosure on or after January 1, 2008, and on or before December 31, 2011.

(3) Each borrower's transaction must meet the following requirements for the borrower to receive an NMS Payment:[2]

(i) The borrower's first-lien mortgage loan was secured by a one-to-four-unit residential property that the borrower had indicated at the time of loan origination was to be used as the borrower's principal residence;

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[1] Oklahoma did not join in the National Mortgage Settlement, and borrowers in Oklahoma are not eligible for its direct relief measures to borrowers. Borrowers with property in Puerto Rico and other American territories also are not eligible.

[2] The servicers provided lists of loans that met these five criteria.

(ii) The borrower's mortgage loan was serviced by one of the five bank mortgage servicers;

(iii) The borrower made at least three payments on the first-lien mortgage loan;

(iv) The loan went to foreclosure sale on or after January 1, 2008, and on or before December 31, 2011; and

(v) The unpaid principal balance of the first-lien mortgage loan did not exceed the government sponsored enterprise (GSE) loan limit for the property securing the loan (for example, $729,750 for a one-unit residence).

(4) For each NMS Payment, there must be certification by (or for) the borrower under penalties of perjury that—

(i) The borrower owned and occupied (or intended to own and occupy) the property (or a unit thereof) as his or her principal residence at the time the borrower obtained the mortgage loan;

(ii) The borrower lost the principal residence in foreclosure on or after January 1, 2008, and on or before December 31, 2011; and

(iii) The borrower lost the principal residence in foreclosure because—

(a) The borrower was unable to make payments on the first-lien mortgage loan due to a financial hardship; and/or

(b) The mortgage servicer mishandled the borrower's application for a loan modification or other foreclosure alternative or pursued

foreclosure while the application was pending or after it was approved; and/or

(c) The mortgage servicer, foreclosure trustee, or their attorneys made errors in, or leading up to, the foreclosure process.

The NMS Payment for each loan is the same amount (approximately $1,400). (If more than one of the co-borrowers on a loan filed claims, they share a single NMS Payment from the Fund.) A borrower could receive the NMS Payment without having to prove financial harm and without having to release any claims. However, under the terms of the National Mortgage Settlement, the NMS Payment offsets and reduces any other obligation that a servicer has to the borrower to provide compensation or other payments.

The National Mortgage Settlement agreements provide that an NMS Payment is remedial and relates to the reduced proceeds a borrower is deemed to have realized in a foreclosure because of the servicers' allegedly unlawful conduct. The agreements do not consider the NMS Payment to be forgiven debt.

The Fund began making the NMS Payments to eligible borrowers in the summer of 2013.[3] In the case of a deceased eligible borrower, the Fund generally issues payment for the claim in the name of the borrower.[4]

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[3] The National Mortgage Settlement also requires the servicers to make other payments to the federal and state governments. Each state has the option of using a portion of those other funds to increase the amount paid to borrowers from that state who lost their homes in foreclosure. This revenue ruling does not address payments of these additional amounts.

[4] There are two exceptions—

- In the case of the death of one spouse, the NMS payment is made in the sole name of the surviving spouse.

FACTS

Situation 1—Loss on a single-unit home. In 2006, Borrower *A* purchased a property for its fair market value of $230,000. *A* financed $200,000 of the purchase price with a recourse first-lien mortgage loan that was secured by the property, and *A* used the property as *A*'s principal residence. During 2011, *A*'s principal residence was foreclosed on when its fair market value was $125,000. The lender subsequently sold the principal residence and applied the proceeds in final satisfaction of the principal balance of the first-lien mortgage loan, which was $185,000. *A*'s adjusted basis in the principal residence at the time of the foreclosure was $230,000. In 2013, *A* received an NMS Payment of $1,400 from the Fund.

Situation 2—Loss on a multiple-unit home. The facts are the same as in *Situation 1*, except that the borrower was *B*, and the property has two identical dwelling units. *B* used one unit as a principal residence and leased the other to a third party at fair rental value. *B*'s entire property was foreclosed on and subsequently sold by the lender. *B*'s adjusted basis in the entire property at the time of the foreclosure was $200,000, of which $115,000 was allocable to the portion of the property *B* used as a principal residence. Half of the property's fair market value at the time of the foreclosure ($62,500) was allocable to the portion of the property that *B* used as a principal residence. In 2013, *B* received an NMS Payment of $1,400 from the Fund.

- If an affidavit, an indemnity agreement, and a death certificate are submitted, the NMS payment is made in the name of the submitter.

Situation 3—Gain on a multiple-unit home. The facts are the same as in *Situation 2*, except that the purchase price was $155,000; and, at the time of the foreclosure—

- The property's fair market value was $160,000;
- Half of the property's fair market value ($80,000) was allocable to the portion of the property that *B* used as a principal residence;
- *B*'s adjusted basis in the entire property was $125,000; and
- $77,500 of the total adjusted basis was allocable to the portion of the property that *B* used as a principal residence.

Situation 4—Gain on a single-unit home. In 1980, Borrower *C* purchased a property for $155,000. *C* financed $130,000 of the purchase price with a recourse first-lien mortgage loan secured by the property. *C* continuously used the property as *C*'s principal residence. *C* refinanced the mortgage loan for an amount in excess of its outstanding principal balance with a new recourse first-lien mortgage loan secured by the principal residence, and used the proceeds to pay for educational expenses of *C's* children and to purchase a boat for personal use.

In 2009, *C's* principal residence was foreclosed on when its fair market value was $160,000. The lender subsequently sold the principal residence and applied the proceeds in final satisfaction of the principal balance of the new loan, which was $215,000. *C*'s adjusted basis in the principal residence at the time of the foreclosure was $155,000. In 2013, *C* received an NMS Payment of $1,400 from the Fund.

Situation 5—Single-unit home with gain less than prior depreciation. In 2000, Borrower *D* purchased a property for $155,000. *D* financed $130,000 of the purchase price with a recourse first-lien mortgage loan secured by the property. *D* used a portion of the principal residence as an office in *D's* business and claimed depreciation deductions of $10,000.

In 2009, *D*'s principal residence was foreclosed on when its fair market value was $149,000. The lender subsequently sold the principal residence and applied the proceeds in final satisfaction of the principal balance of the loan, which was $175,000 due to subsequent refinancings. D's adjusted basis in the principal residence at the time of the foreclosure was $145,000. *D* did not sell any other property during 2009. In 2013, *D* received an NMS Payment of $1,400 from the Fund.

Situation 6—Single-unit home with gain greater than prior depreciation. The facts are the same as in Situation 5, except that the fair market value of the property at the time of the foreclosure was $154,500.

Situation 7—Deceased borrower. The facts are the same as in Situation 5, except that *D* died before the NMS Payment was made.

LAW AND ANALYSIS

Section 61(a)(3) of the Internal Revenue Code provides that, except as otherwise provided in subtitle A, gross income includes gains derived from dealings in property.

Section 121(a) generally provides, with certain limitations and exceptions, that gross income does not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, the taxpayer has owned and

used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

Section 121(d)(6) provides that the exclusion from income under § 121(a) does not apply to that part of the gain from the sale of any property that does not exceed the depreciation adjustments (as defined in § 1250(b)(3)) attributable to the property for periods after May 6, 1997. See § 1.121-1(d) for an example that illustrates this rule.

Section 1.121-1(e)(1) provides that § 121 does not apply to the gain allocable to any portion of the property (separate from the dwelling unit) sold or exchanged for which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for nonresidential purposes, only the gain for the residential portion is excludable under § 121.

Section 1.121-1(e)(3) provides that for purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments (as defined in § 1250(b)(3)), if applicable.

Under § 1.121-1(e)(1), no allocation of the gain from the sale or exchange of property is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, § 121 does not apply to the gain allocable to the residential portion of the property to the extent provided by § 121(d)(6) and

§ 1.121-1(d). Thus, if the taxpayer's adjusted basis in the dwelling unit reflects any prior depreciation deductions allowed or allowable on the dwelling unit, then the exclusion under § 121 is limited to the gain in excess of the depreciation deductions allowed or allowable. *See* § 1250(b)(3).

Section 165(a) allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

For an individual, § 165(c) generally limits the deduction for losses to—

- losses incurred in a trade or business;
- losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- losses of property not connected with a trade or business or a transaction entered into for profit that arise from fire, storm, shipwreck, or other casualty, or from theft.

Section 691(a)(1) provides that the amount of all items of gross income in respect of a decedent that are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year in which received, of—

- the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

- the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or
- the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

Section 1.691(a)-1(b) provides that the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income, but which were not properly includible in computing the decedent's taxable income for the taxable year ending with the date of the decedent's death or for a previous taxable year under the method of accounting employed by the decedent.

Section 691(a)(3) provides that the right to receive an amount of income in respect of a decedent shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income shall be considered, in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such income.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011

for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1.1001-1(a) states that the amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received.

Section 1.1001-2(a)(1) generally provides that the amount realized on a sale or disposition of property includes the amount of the liabilities from which the transferor is discharged as a result of the sale or disposition. Under § 1.1001-2(a)(2), however, the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under § 61(a)(12).

In each situation in this revenue ruling, the borrower incurred recourse debt secured by property used (in whole or in part) as the borrower's principal residence, and the foreclosure of the property resulted in final satisfaction of the outstanding balance of the recourse debt. Thus, under § 1001 and its regulations, the amount realized by each borrower on the disposition of the property in the foreclosure equals the fair market value of the property.[5]

To determine the federal income tax treatment of a settlement payment, "the test is not whether the action was one in tort or contract, but rather the question to be asked is 'In lieu of what were the damages awarded?'" *See Raytheon Production Corp. v.*

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[5] This revenue ruling addresses recourse mortgage loans. If the borrower's mortgage loan was a nonrecourse loan, the debt that was discharged in the foreclosure would be included in the borrower's amount realized from the disposition of the property. Regardless of whether the mortgage loan was recourse or nonrecourse, the NMS Payment is an additional amount realized from the foreclosure.

Commissioner, 144 F.2d 110, 113 (1st Cir. 1944), *aff'g* 1 T.C. 952 (1943). Here, as reflected in the settlement documents, the NMS Payment from the Fund is an additional amount realized on the foreclosure of the borrower's principal residence. That amount realized is used to determine any gain or loss realized under § 1001, including gain that may be excluded under § 121.

In addition, an NMS Payment is intended to compensate a borrower for loss of a principal residence rather than for loss on other property. This intention is indicated by the fact that only borrowers who lost their principal residence may receive the payment. Consequently, for purposes of § 1001, § 121, and § 1.121-1(e), if a taxpayer receives an NMS Payment for loss of a multiple-unit property a portion of which was used as the taxpayer's principal residence, then the entire NMS Payment is allocable to the portion of the property used as a principal residence.

A taxpayer that receives a deceased eligible borrower's NMS Payment "stands in the shoes" of the borrower for purposes of determining the tax consequences of that payment. Any gain not excluded from gross income under § 121 is income in respect of a decedent within the meaning of § 691(a).

Situation 1—Loss on a single-unit home. In 2011, *A*'s amount realized on the foreclosure of the principal residence was $125,000, its fair market value. *A*'s adjusted basis in the principal residence ($230,000) exceeded *A's* amount realized ($125,000). Thus, *A* realized a $105,000 ($230,000 – $125,000) loss on the foreclosure. Under § 165(c), this loss is not deductible because *A*, an individual, did not incur the loss in a trade or business, a transaction entered into for profit, or as a result of a casualty. The

NMS Payment of $1,400 that *A* received in 2013 reduces *A*'s nondeductible loss to $103,600 and thus does not increase *A*'s taxable income.

Situation 2—Loss on a multiple-unit home. In 2011, *B*'s adjusted basis in the portion of the property that *B* used as a principal residence ($115,000) exceeded *B*'s amount realized from the foreclosure of that portion of the property ($62,500). Thus, *B* realized a loss of $52,500 ($115,000 - $62,500) on the portion of the property *B* used as a principal residence, which is not deductible under § 165(c). The entire NMS Payment of $1,400 that *B* received in 2013 is allocable to the portion of the property *B* used as a principal residence. The allocated amount reduces *B*'s nondeductible loss to $51,100 and thus does not increase B's taxable income.

Situation 3—Gain on a multiple-unit home. In 2009, *B*'s amount realized on the foreclosure of the portion of the property *B* used as a principal residence ($80,000) exceeded *B*'s adjusted basis ($77,500) in that portion of the property. Thus, *B* had a $2,500 ($80,000 – $77,500) gain on the foreclosure of the principal residence. *B* excludes this gain from gross income under § 121 because *B* owned and used that portion of the property as a principal residence for at least two of the five years preceding the sale. The entire NMS Payment of $1,400 that *B* received in 2013 is allocable to the portion of the property *B* used as a principal residence, thus increasing *B's* gain (and the amount excluded under § 121) on the foreclosure of the principal residence to $3,900.

Situation 4—Gain on a single-unit home. In 2009, *C*'s amount realized on the foreclosure of the principal residence was $160,000, its fair market value. *C*'s amount

realized ($160,000) exceeded *C*'s adjusted basis ($155,000). Thus, *C* had a $5,000 ($160,000 – $155,000) gain on the foreclosure of the principal residence. *C* excludes this gain from gross income under § 121 because *C* owned and used the property as a principal residence for at least two of the five years preceding the sale. The NMS Payment of $1,400 that *C* received from the Fund in 2013 increases *C's* gain (and the amount excluded under § 121) on the foreclosure to $6,400.

Situation 5—Single-unit home with gain less than prior depreciation. In 2009, *D*'s amount realized on the foreclosure of the principal residence ($149,000) exceeded *D*'s adjusted basis in the principal residence ($145,000). Thus, *D* realized a gain of $4,000 ($149,000 – $145,000) on the foreclosure of the principal residence. Under § 121(d)(6), however, because the $4,000 gain did not exceed *D*'s depreciation deductions of $10,000, *D* could not exclude that gain from income under § 121, and *D* includes the $4,000 gain in income under § 61(a)(3) in 2009. Similarly, under § 121(d)(6), *D* may not exclude from income the additional $1,400 gain that D realizes as a result of the NMS Payment of $1,400 that *D* receives in 2013. The NMS Payment increases the gain on the property to $5,400, which does not exceed *D*'s depreciation deductions. Thus, none of the $5,400 gain is excludable from gross income. Under § 61(a)(3), *D* must include the NMS Payment of $1,400 in income on *D*'s federal income tax return for 2013, the year in which *D* received the NMS Payment. See § 1.121–1(d) for rules on determining the character of this income.

Situation 6—Single-unit home with gain greater than prior depreciation. Because the amount realized on the foreclosure was $154,500, the NMS Payment of $1,400

increased the gain to $10,900 (($154,500 – $145,000) + $1,400), which exceeds the depreciation deductions by $900. Thus, *D* includes $500 of the additional gain resulting from the NMS Payment in gross income under § 121(d)(6) on *D*'s federal income tax return for 2013, and excludes the remaining $900 from gross income under § 121(a). See § 1.121-1(d) for rules on determining the character of the amount that is included in income.

Situation 7—Deceased borrower. Because *D* died before payment was made, the person(s) with a right to *D*'s NMS Payment must treat the entire amount received as income in respect of a decedent under § 691(a) because, if *D* had lived, *D* could not have excluded any of the NMS Payment from income pursuant to § 121(d)(6). See § 691(a)(3) and § 1.121-1(d) for rules on determining the character of the amount that is included in income.

HOLDINGS

1. A taxpayer who receives an NMS Payment pursuant to the National Mortgage Settlement due to the foreclosure of the taxpayer's principal residence includes the payment in the amount realized on the foreclosure under § 1001.

2. If a taxpayer includes an NMS Payment in the amount realized and, as a result, creates or increases a gain on the foreclosure of the principal residence, the taxpayer may exclude the resulting gain from gross income to the extent permitted under § 121, including the limitation in § 121(d)(6) that gain attributable to depreciation cannot be excluded from gross income.

3. If the property for which a taxpayer receives an NMS Payment contained one or more additional dwelling units that were not used as the taxpayer's principal residence, the entire NMS Payment is allocable to the portion of the property that the taxpayer used as a principal residence.

4. A taxpayer who receives any portion of a deceased borrower's NMS Payment stands in the shoes of the borrower to determine the taxable portion, if any, of the NMS Payment. Any taxable amount is income in respect of a decedent under § 691(a).

DRAFTING INFORMATION

The principal author of this revenue ruling is Shareen S. Pflanz of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Shareen S. Pflanz at (202) 622-4920 (not a toll-free call).

Special information relating to

Purchase Money Mortgages, Purchase Money Security Interests, and Subordination of the Federal Tax Lien

If the IRS has recorded a Notice of Federal Tax Lien (NFTL) against you and you are trying to obtain a loan to buy real or personal property, the following questions frequently arise:

Does the lien prevent a bank, mortgage company, or other lender from lending you money to buy a house, a motor vehicle, or other consumer goods or property?

When a loan is made to purchase real property, the lender may obtain a Purchase Money Mortgage (PMM); when a loan is made to purchase personal property, the lender may obtain a Purchase Money Security Interest (PMSI). Provided all requirements of state law are complied with, these types of financing agreements allow lenders to finance the purchase of real and personal property even though a NFTL has been filed against you.

If you borrow money from a lender for such a purpose and give the lender a security interest in the property purchased with the proceeds of the loan, will the lender's security interest have priority over the tax lien?

In 1968 the Internal Revenue Service published Revenue Ruling 68-57, which states that it is the position of the IRS that a PMM or a PMSI given in good faith to secure a loan for the purchase of real property or goods, has priority over an already recorded Notice of Federal Tax Lien. *(See Revenue Ruling 68-57 at the end of this publication.)*

Is it necessary for the Internal Revenue Service to issue a certificate of subordination giving the security interest priority over the NFTL?

It is not necessary for the Internal Revenue Service to issue a certificate of subordination in order for the lender's PMM or PMSI to have priority over the lien.

In order for the PMM or PMSI to have priority over the lien, the PMM or PMSI must meet all of the requirements under state law, including the following. The PMI or PMSI must:

Be allowed under local law – The creation of a PMM or a PMSI is based on state law. While allowed by all states, you or your lender should be familiar with the laws of the state in which you live. Make sure that your state's law does not put a limit on the dollar amount of a PMM or a PMSI.

The proceeds of the loan must be used to purchase the property – The PMM or PMSI will have priority over the federal tax lien in the property you are purchasing in an amount equal to the proceeds of the loan that are directly used to purchase the property.

If the PMM or PMSI must be recorded – Make sure that the PMM or PMSI is recorded in the place directed by your state's law, and that it is recorded within any time frame that your state's law may require.

If the security interest that will be securing the loan you are making qualifies for the priority given to a PMM or a PMSI, you do not need a certificate of subordination from the Internal Revenue Service, and a certificate will not be provided if applied for.

If you or your lender have any questions about whether your loan is being secured by a qualifying purchase money mortgage or purchase money security interest, please call or write the Technical Services (Advisory) office in your area. Contact information is found in Publication 4235, *Technical Services (Advisory) Group Addresses*.

Revenue Ruling 68-57

Section 6321 – LIEN FOR TAXES

26 cfr 301.6321-1: Lien for Taxes
Rev.Rul. 68-57

The Federal Tax Lien Act of 1966, P.L. 89-719, C.B. 1966-2, 623, does not refer to a purchase money security interest of mortgage. However, the General Explanation of the Act, as set forth in House of Representatives Report No. 1884, C.B. 1966-2, at page 817, states as follows:

Although so-called purchase money mortgages are not specifically referred to under present law, it has generally been held that these interests are protected whenever they arise. This is based upon the concept that the taxpayer has acquired property or a right to property only to the extent that the value of the whole property or right exceeds the amount of the purchase money mortgage. This concept is not affected by the bill.

In view of the legislative history of the Federal Tax Lien Act of 1966, the Internal Revenue Service will consider that a purchase money security interest or mortgage valid under local law is protected even though it may arise after a notice of Federal tax lien has been filed.

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IRS Announces Guidance on the Principal Reduction Alternative Offered in the Home Affordable Modification Program (HAMP)

IR-2013-8, Jan. 24, 2013

WASHINGTON — The Internal Revenue Service today announced guidance to borrowers, mortgage loan holders and loan servicers who are participating in the Principal Reduction Alternative℠ offered through the Department of the Treasury's and Department of Housing and Urban Development's Home Affordable Modification Program® (HAMP-PRA®).

To help financially distressed homeowners lower their monthly mortgage payments, Treasury and HUD established HAMP, which is described at www.makinghomeaffordable.gov. Under HAMP-PRA, the principal of the borrower's mortgage may be reduced by a predetermined amount called the PRA Forbearance Amount if the borrower satisfies certain conditions during a trial period. The principal reduction occurs over three years.

More specifically, if the loan is in good standing on the first, second and third annual anniversaries of the effective date of the trial period, the loan servicer reduces the unpaid principal balance of the loan by one-third of the initial PRA Forbearance Amount on each anniversary date. This means that if the borrower continues to make timely payments on the loan for three years, the entire PRA Forbearance Amount is forgiven. To encourage mortgage loan holders to participate in HAMP–PRA, the HAMP program administrator will make an incentive payment to the loan holder (called a PRA investor incentive payment) for each of the three years in which the loan principal balance is reduced.

Guidance on Tax Consequences to Borrowers

The guidance issued today provides that PRA investor incentive payments made by the HAMP program administrator to mortgage loan holders are treated as payments on the mortgage loans by the United States government on behalf of the borrowers. These payments are generally not taxable to the borrowers under the general welfare doctrine.

If the principal amount of a mortgage loan is reduced by an amount that exceeds the total amount of the PRA investor incentive payments made to the mortgage loan holder, the borrower may be required to include the excess amount in gross income as income from the discharge of indebtedness. However, many borrowers will qualify for an exclusion from gross income.

For example, a borrower may be eligible to exclude the discharge of indebtedness income from gross income if (1) the discharge of indebtedness occurs (in other words, the loan is modified) before Jan. 1, 2014, and the mortgage loan is qualified principal residence indebtedness, or (2) the discharge of indebtedness occurs when the borrower is insolvent. For additional exclusions that may apply, see Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals).

Borrowers receiving aid under the HAMP–PRA program may report any discharge of indebtedness income — whether included in, or excluded from, gross income — either in the year of the permanent modification of the mortgage loan or ratably over the three years in which the mortgage loan principal is reduced on the servicer's books. Borrowers who exclude the discharge of indebtedness income must report both the amount of the income and any resulting reduction in basis or tax attributes on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).

Guidance on Tax Consequences to Mortgage Loan Holders

The guidance issued today explains that mortgage loan holders are required to file a Form 1099-C with respect to a borrower who realizes discharge of indebtedness income of $600 or more for the year in which the permanent modification of the mortgage loan occurs. This rule applies regardless of when the borrower chooses to report the income (that is, in the year of the permanent modification or one-third each year as the mortgage loan principal is reduced) and regardless of whether the borrower excludes some or all of the amount from gross income.

Penalty relief is provided for mortgage loan holders that fail to timely file and furnish required Forms 1099-C, as long as certain requirements described in the guidance are satisfied.

Details are in Revenue Procedure 2013-16 available on IRS.gov.

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