

## **Mortgage debt relief extension, tax relief for community banks, and crackdown on some executive compensation in the 2008 Economic Stabilization Act**

The Emergency Economic Stabilization Act of 2008 was enacted Oct. 3, 2008. Those provisions are: (1) an extension for home mortgage debt forgiveness relief, (2) tax relief for community banks that invested in Fannie Mae and Freddie Mac preferred stock, and (3) a tax crackdown on compensation and severance pay for certain financial executives. The key details regarding those provisions are:

### ***Two-year extension of home mortgage debt forgiveness relief provision.***

The new law provides assistance to homeowners who have been caught in the current mortgage crisis and are trying to save their homes. Under 2007 tax legislation, taxpayers are generally allowed to exclude up to \$2 million of mortgage debt forgiveness on their principal residence. However, this relief provision was scheduled to expire at the end of 2008. Under the new law, this debt relief provision is extended through 2012. To understand the importance of this relief provision, one needs to know that for income tax purposes, a discharge of indebtedness—that is, a forgiveness of debt—is generally treated as giving rise to income that's includible in gross income. Under pre-2007 tax law, there were no special rules applicable to discharges of acquisition debt on the taxpayer's principal residence. For example, assume a taxpayer who wasn't in bankruptcy and wasn't insolvent owned a principal residence subject to a \$200,000 mortgage debt for which the taxpayer had personal liability. The creditor foreclosed and the home was sold for \$180,000 in satisfaction of the debt. Under pre-2007 tax law, the debtor had \$20,000 of debt discharge income. The result was the same if the creditor restructured the loan and reduced the principal amount to \$180,000. In 2007 the tax laws were temporarily changed to allow taxpayers to exclude up to \$2 million of mortgage debt forgiveness on their principal residence. For example, assume the same facts as in the foregoing example except that the discharge occurs in 2008. In that case the debtor has no debt discharge income when the creditor (1) restructures the loan and reduces the principal amount to \$180,000 or (2) forecloses with the result that the \$200,000 debt is satisfied for \$180,000. However, this debt relief provision was scheduled to expire at the end of 2009. The new legislation extends the provision through 2012. The relief is not extended to home equity loans.

### ***Tax relief for community banks.***

Some 800 community banks had huge losses on their Fannie Mae and Freddie Mac preferred stock holdings which became worthless when the government bailed those companies out. Without a tax change, these community banks would have had capital losses on these holdings that they couldn't utilize. The new legislation allows community banks to treat losses on their Fannie Mae and Freddie Mac preferred stock as ordinary losses that can offset ordinary income. Applying to any preferred stock that was owned on Sept. 6, 2008, or sold between Jan. 1, 2008, and Sept. 6, 2008, this provision allows banks to claim the book benefit of the loss on their tax returns, thereby reducing their need to obtain additional capital from the FDIC or investors.

### ***Tax crackdown on compensation and severance pay for certain financial executives.***

Under the new law, when more than \$300 million of a company's assets are purchased by the Treasury through an auction, (1) "golden parachute" payments are banned for top executives hired while the Treasury rescue is in effect and (2) tax provisions kick in to strengthen the tax treatment of remaining executive compensation and severance packages. Specifically, the deductibility of executive compensation for companies will be cut in half from pre-Act levels, and companies will also lose deductions available under pre-Act law for excessively large severance packages. Executives receiving severance packages will continue to face a 20% excise tax on payments once they reach an excessive threshold, and that tax will be due if the executive leaves for reasons other than a standard retirement for which they are eligible—not just if the company changes hands, as in pre-Act law.