MORTGAGES; Relief for Distressed Borrowers

By BOB
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WHEN President Bush signed the Mortgage Forgiveness Debt Relief Act into law late last month, the move touched off a now-familiar debate among housing advocates and analysts: will it have much impact?

Bankruptcy lawyers said that the measure, which grants tax relief to people trying to save their homes, would have limited effect in the New York area and beyond. But housing counselors were far more optimistic.

''It's no panacea, but we think it's a real good step in the right direction,'' said Colleen Hernandez, the executive director of the Homeownership Preservation Foundation, a nonprofit organization that provides counseling for borrowers facing foreclosure, among others. ''Along with some of the other efforts being put in place, it spells relief in an important way.''

The legislation reverses a longstanding tax policy that treated forgiven housing debt as income. So when a financially distressed borrower worked out a new mortgage with a lender that essentially reduced the borrower's debt by $30,000, for example, the borrower was required to include that amount as taxable income on his or her tax return.

Housing advocates said this policy discouraged some borrowers from seeking ''work around'' arrangements.

According to Ms. Hernandez, the Homeownership Preservation Foundation, which provides free telephone counseling, advised about 700 people in one day in late December. Of those, about 25 percent were in a situation where their best hope for keeping a home was a ''short sale,'' in which a borrower sells a house for less than the mortgage amount, and the lender forgives the remaining debt. ''When you remove the impediment of paying taxes on that so-called profit,'' she said, ''it's a big help.''

Some bankruptcy lawyers disagree. Jay Fleischman, the president of the Bankruptcy Law Network, a consortium of independent bankruptcy lawyers, said, ''I think the new law is a lot of window dressing.''

Mr. Fleischman, whose practice is based in Brooklyn, said that as long as a homeowner is deemed insolvent, forgiven mortgage debts are not recorded as taxable income. ''You don't even have to go into bankruptcy,'' he said.

Mr. Fleischman and other bankruptcy lawyers in the New York region said they had seen a sharp rise in mortgage-related bankruptcy inquiries in the last year, and expected more as rates on adjustable-rate mortgages, or ARMs, rise beyond the discounted introductory level.

The Bush administration announced last month that lenders would freeze ''teaser rates'' on ARMs made to those with poor credit, but only for borrowers who had been keeping up with their payments and who could not afford higher payments.

That is precisely the type of borrower who will benefit from the Mortgage Forgiveness Debt Relief Act, said Diane Gray, the director of counseling and education at Novadebt, a nonprofit debt counseling group based in Freehold, N.J.

Because these borrowers are not yet insolvent -- but probably will be when their interest rates rise -- the tax relief will help.

In areas with falling real estate prices, borrowers looking to rework their mortgages with lenders often face a situation in which their mortgage is suddenly higher than the value of their home.

In such instances, a refinanced mortgage could include forgiveness of outstanding debt. "For these people," Ms. Gray said, "it's fantastic that they won't have to worry about tax issues."