



Foreclosure tax double whammy eased

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As the subprime mortgage crisis has escalated, struggling homeowners have been hit with a double whammy: loss of their homes to foreclosure followed by an unexpected tax bill.

But thanks to a new law, some homeowners now will see their tax liability in these cases eliminated.

The Mortgage Debt Forgiveness Act of 2007 covers what many unsuspecting homeowners saw as punishment of the homeowner for a lender's seemingly benevolent move -- the writing off, or forgiveness, of some of a mortgage loan.

Under prior law, when a home's value decreased and the lender and borrower negotiated a reduction in loan principal, the difference between the original and new debt was taxable income. A homeowner also could face similar tax liability when the lender completed a foreclosure and sold the home for less than the outstanding mortgage.

Officially, it is known as cancellation of debt, or COD income. It also is sometimes called discharge of indebtedness income or debt forgiveness. Regardless of the name, it produced a homeowner tax bill, generally calculated at ordinary rates ranging from 10 percent to 35 percent depending upon the homeowner's income.

"What the (previous) tax law essentially did was treat the foreclosure as a sale by the debtor, the owner of the property, with the proceeds being paid to the lender," says Frederick M. Stein, RIA senior analyst from Thomson Tax & Accounting.

Now, however, some homeowners who renegotiate their mortgages within a three-year window -- the law applies to transactions retroactively from Jan. 1, 2007, through Dec. 31, 2009 -- will not face any taxes on debt forgiven in the process.

In signing the measure into law, President Bush lauded the benefits of the temporary tax abatement.

"When you're worried about making your payments, higher taxes are the last thing you need to worry about," said Bush. "So this bill will create a three-year window for homeowners to refinance their mortgage and pay no taxes on any debt forgiveness that they receive. ... The provision will increase the incentive for borrowers and lenders to work together to refinance loans and it will allow American families to secure lower mortgage payments without facing higher taxes."

Still some restrictions

Although mortgage-related COD income is off the tax books for the next three years, some homeowners facing financial difficulty could still end up facing an IRS bill.

There is a \$2 million limit on the amount of COD income that escapes taxation.

The loan must be to buy, build or substantially improve a principal residence, i.e., the property in which the homeowner lives. Debt forgiven on vacation or investment properties or a second home will still count as income.

And homeowners who took advantage of the run-up in real estate prices to refinance their mortgages can only use the new law in connection with higher mortgage debt that was used to improve the home. Such cash-out refinancings where the homeowner took out money to pay for purchases, such as a vehicle or to pay off credit card debt, don't qualify for the exclusion if they are forgiven.

Mark Luscombe, principal federal tax analyst with CCH, a tax software and publishing company in Riverwoods, Ill., says that taxpayers who take advantage of the new law will have to reduce their basis in their homes by the amount excluded. For example, someone who paid \$300,000 for a house and had \$20,000 in mortgage debt forgiven will figure that their basis in their home is now \$280,000. If they later sell their home for \$350,000, their gain will be \$70,000 rather than \$50,000.

The good news here is that other home-related tax law offers some cover. "Since single people can exclude as much as \$250,000 in gain on the sale of a home, and joint filers as much as \$500,000, in many cases there is no tax due anyway," says Luscombe. "Even if there is, most people would be willing to trade a capital gains tax in the future for tax relief at ordinary income rates today."

The type of mortgage matters

Just how much and what type of tax the IRS expects after a foreclosure also depends in large part on whether the loan is of the recourse or nonrecourse variety.

With a recourse loan, the debtor is personally liable for the debt. In a foreclosure, it means if the property sale proceeds are not enough to cover the outstanding mortgage, the debtor must pay the difference. This includes interest that accrues during the foreclosure process.

A nonrecourse debt, however, is secured by the loan collateral. If money from sale of the property doesn't cover the outstanding debt, the lender has no legal ability to get the additional funds from the debtor.

"In nonrecourse situations, you have a house, the mortgage and the market value of whatever the bank can sell it for and put toward the outstanding loan," says Ted Lanzaro, CPA and owner of his own accounting firm in Shelton, Conn. "If the house is worth \$100,000 and there is a \$110,000 loan on it, the bank in a nonrecourse situation cannot go after the borrower for that \$10,000 difference."

Cancellation of debt income and its tax implications typically come into play with recourse loans. If the house's fair market sales price is less than the unpaid mortgage and the lender forgives the remaining mortgage debt, that amount is taxable income at ordinary tax rates.

But now, under the new law, homeowners with recourse loans also can avoid associated tax liability.

A sale is a sale is a sale

With either type of mortgage, a foreclosed-upon homeowner could end up owing capital gains taxes without ever receiving any money from the foreclosure sale.

"Foreclosure is not a sale in normal terms, but it is still treated under tax code as a sale," says Stephen Trenholm, CPA and tax manager at Rucci Bardaro & Barrett in Boston.

"The outstanding balance of the mortgage is compared to the basis in house. If that produces a gain, it's a taxable gain. If it's a nonrecourse mortgage, it's a capital gain."

Let's assume the example homeowner mentioned earlier has nonrecourse mortgage debt of \$110,000 and an adjusted basis of \$20,000 in the home, which has a fair market value of \$100,000. The owner has no ordinary tax liability for that \$10,000 difference in his debt and the home's value. But when a nonrecourse mortgage is foreclosed and that debt is greater than the home's value, the property is treated for tax purposes as if it were sold for the balance of the mortgage.

That means this homeowner would have a \$90,000 difference between the mortgage debt and his basis (\$110,000 less \$20,000) and that \$90,000 is taxable capital gain from the "sale or other disposition" of the home. So even though the foreclosed-upon owner didn't get any cash from the transaction, he still owes taxes on what is known as phantom income. The only good news is that the taxes are collected at the lower 15 percent (or 5 percent for lower-income taxpayers) capital gains rate.

If that same homeowner's mortgage was recourse debt and his lender canceled the \$10,000 difference between the outstanding loan and the home's fair market value, the foreclosed-upon owner would owe higher, ordinary taxes on that forgiven 10 grand. In addition, his capital gains bill would be based on \$80,000 -- the property's fair market value of \$100,000, less his \$20,000 adjusted basis.

For some struggling homeowners, the taxes on forgiven debt or phantom income are all too real, prompting the temporary law change late last year.

"If it's \$10,000, that's a relatively small spread; \$2,000 to \$2,500 in federal and state taxes," says Lanzaro. "But it's not just the working man having this problem. Everybody's getting in over their head these days. If you have a \$700,000 mortgage and the bank can only get \$500,000 in a foreclosure sale, now you're talking about some tax liability."

Home-sale exclusion opportunity

There is one bit of good news for our hypothetical homeowner and others dealing with foreclosure-induced taxes. You can get out from under at least part of the IRS bill if you meet the homeownership tax-exclusion rules.

That's right. Even though you aren't selling the house and the bank is, the IRS views the transaction as if you were the seller. That means you could owe taxes on the sale. The bad news comes directly from the IRS, via Publication 544:

"If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which you may realize gain or loss. This is true even if you voluntarily return the property to the lender. ... You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The

gain or loss is the difference between your adjusted basis in the transferred property and the amount realized."

Those calculations also take into consideration any cancellation of debt income and the type of mortgage.

So yes, you could indeed pay tax on the money that was used to pay back the mortgage even though you don't get any of it.

The popular home sale gain exclusion allows a single homeowner who sells his property under more favorable circumstances to exclude up to \$250,000 profit from taxes; the exclusion is \$500,000 for married couples filing jointly.

The exclusion also applies in foreclosures. As long as the seller, in this case the foreclosed-upon owner, lived in the home as his principal residence for two of the last five years, he also can avoid taxes on any capital gain profit, phantom or real.

Bankruptcy and insolvency solutions

Two other circumstances offer tax relief in foreclosures, but both could cause other financial problems.

If a homeowner can show he's insolvent before the discharge of the mortgage and turnover of the property, as well as afterward, any proceeds are not taxed. However, says Trenholm, "insolvency is a little tricky. There's no strict definition of what assets (go in the calculation), but for the most part, a lot of people caught in the real estate crunch can establish that condition."

The other option is bankruptcy.

"Forgiveness debts, in these cases, are not taxed," says John W. Roth, senior tax analyst at CCH. "They don't want the bank chasing them down, which is why many times people going through foreclosure also go through bankruptcy."

However, filing for bankruptcy has its own set of considerations. "New bankruptcy rules don't give (filers) a lot of relief," says William S. Bost, a member of the Raleigh, N.C.-based law firm Ragsdale Liggett PLLC. "If you have a job and are making money, the new bankruptcy rules don't give you a whole lot of help. It gives you some time, but I don't think that's necessarily the way to go.

"It used to be like going to church, you walk in and walk out absolved, but it's not like that anymore," says Bost. "Now, it's not worth the pain you pay the rest of your life."