

Mortgage Mess

Unanticipated Tax Consequences For Homeowners



Homeowners who over-extended themselves with creative financing arrangements and exotic loan terms are now facing some unpleasant and unanticipated provisions of the Tax Code. Not only are homeowners with the overwhelming possibility of losing their homes either voluntarily through selling at a loss or involuntarily through foreclosure, but many also must accept certain tax consequences for which they are totally unprepared.

No Deduction or carryover basis. There are no deductions available for taking a loss on the sale of one's primary residence. When the net sale price of the homeowner's home is less than his or her tax basis, the loss incurred on the sale is considered a nondeductible personal expense for federal income tax purposes. What's more, if a homeowner eventually purchases a second home and sells that property down the road at a taxable profit, previous losses cannot be used to offset that gain since basis is no longer carried over.

Conversion. One possibility for homeowners faced with taking a loss on the sale of their home: convert the home into an income-producing property, such as a rental, before an eventual sale. Losses incurred after the property is converted may be deductible as an ordinary loss. However, only the amount of loss incurred after the home becomes a business or investment property is deductible.

Cancelled debt. When a lender forecloses on property, sells the home for less than the borrower's outstanding mortgage and forgives part or all of the unpaid mortgage debt, the Tax Code considers the cancelled debt to be taxable income.

If a lender refuses to discharge the remaining debt, the homeowner is obligated to pay off the loan and there is no tax break or write-off for doing so. A borrower's "cancelled debt income" is taxable at ordinary rates. Few exceptions apply. For example, when borrowers are insolvent or involved in bankruptcy proceedings, discharged debt is not taxable.

Foreclosure and gain. Moreover, if property is foreclosed and sold at auction for more than the home's tax basis, the sale produces taxable capital gain. In this case, however, the gain from a foreclosure sale of an individual's principal residence may be excluded to the extent of up to \$250,000 (\$500,000 for married homeowners filing jointly), depending on the length of homeownership. No exclusion, however, is given on vacation property that is not a principal residence.

Short sales. Lenders that allow homeowners to sell their property when the outstanding mortgage debt exceeds the net sale price of the home also create taxable ordinary income for the homeowner on the difference if the lender accepts proceeds from the sale as payment in full.

Reporting obligations. When a bank or other creditor forgives part or all of a borrower's unpaid mortgage balance, the lender is required to report the cancelled debt amount to the IRS on Form 1099-C (Cancellation of Debt), if the amount forgiven is \$600 or more. Since cancelled debt is income to the borrower, the amount must also be reported by the homeowner on his or her federal income tax return.

The President has proposed and Congress is considering legislation that would ensure that cancelled debt on a primary residence is not counted as income.

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