Doron F. Eghbali Residential Real Estate

Tax Pitfalls of Home Foreclosures

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When a principal residence is foreclosed, the homeowner already in distress might have to pay federal and state income taxes. However, there could be some help available.

SOME BASICS

1. Foreclosure

Foreclosure is when a mortgage lender repossesses a property and sell it to pay off the outstanding debt. Generally, in most cases, a foreclosure occurs when the fair market value of the property (the price a willing and able buyer pays for the property) is less than what the property owner owes the lender. Here, for income tax purposes, such foreclosure is treated as sale and subject to federal and state tax rules.

2. Gain and Loss

In a foreclosure, if the fair market value of the foreclosed property exceeds the tax basis in the property (i.e. the cost to purchase the property plus the costs of any improvements) a gain is realized.

If the fair market value of the property is less than the tax basis, a loss is realized.

3. Cancellation of Debt Income

If a mortgage lender forgives part or all of the debt against your foreclosed property in conjunction with or after the foreclosure transaction, you have cancellation of debt income. This income is taxable, unless an exception applies.

However, not all mortgage lenders forgive the unpaid balance of the mortgage (the so called deficiency). That said, many mortgage lenders in these economic times are amenable to forgiveness. So, cancellation of debt income is more common these days.

A. Exception to Cancellation of Debt Income

Legislation enacted in 2007 and 2008 provided for qualifying cancellations of home mortgage debt during the years 2007 through 2012. The result is if qualified, the cancellation of debt income is NOT TAXED.

To qualify:

- Taxpayer need not be bankrupt or insolvent to take advantage of this provision.
- The debt must have been used to purchase, build or improve a MAIN residence AND secured by that residence.
- Refinance debt is also qualified to the extent the debt was used to purchase, build or improve a MAIN residence.
- You MUST reduce the tax basis of your residence by the amount allowable by the cancellation of debt income, but NOT below zero.

4. Principal Residence Gain Exclusion Break

One important thing to remember is the home-sale tax exclusion break. This tax exclusion allows an unmarried person to deduct up to $250,000 and a married couple up to $500,000 of gains on their principal residence.

To qualify:

- The person must have owned the home for at least two years of the last five years ending on the foreclosure date. *And*,
- The person MUST have used the home as principal residence for at least two years during the last five years.

SOME EXAMPLES

This helps to illustrate these concepts by looking at a couple of examples.

1. Foreclosure with Tax Gain

Let's say your home's fair market value is $425,000 and its tax basis is $400,000. There is a first mortgage of $375,000 and a second mortgage of $100,000. So,the entire debt equals $475,000.

Upon sale of the home by lenders at $425,000, the first mortgage for $375,000 gets paid off. And only $50,000 of the second mortgage gets paid.The second mortgage lender forgives the other $50,000.

Tax Implications

You realized a $25,000 gain ($425,000 Fair Market Value-$400,000 Tax Basis=$25,000). However, this gain could be excluded if you qualify for the principal residence gains exclusion explained earlier.

However, you had cancellation of debt income for $50,000, unless the exception outlined earlier applies.

2. Foreclosure with Tax Loss

Let's say your home's fair market value is $300,000 and its tax basis is $400,000. You have a first mortgage of $275,000 and a second mortgage of $100,000. So, the total debt equals $375,000.

Upon foreclosure, the first mortgage gets paid off. The second lender gets paid only $25,000 ($300,000 Fair Market Value-$275,000 Foreclosure=$25,000). You can scrape up another $25,000 to pay down the second mortgage by $50,000. And the second lender forgives the $50,000.

Tax Implications

You had a loss of $100,000 ($400,000 Fair Market Value-$300,000 Tax Basis=$100,000). However, this loss is a NONDEDUCTIBLE PERSONAL EXPENSE, for both federal and state income purposes.

The $50,000 forgiven by the second lender is cancellation of debt income unless the exception delineated earlier applies.

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