THE WALL STREET JOURNAL.
WSJ.com

WEEKEND INVESTOR | MAY 8, 2010

A Surprise Tax Hit on Foreclosures

For People Who Lose or Walk Away From Their Homes, A Big Tax Bill May Loom

By JEFF D. OPDYKE

Maxine McDaniel has a message for Americans considering walking away from an unaffordable mortgage: Beware of taxes.

Though not every homeowner who's underwater on a mortgage need worry, many are finding that a foreclosure or other form of housing loss can lead to a big tax obligation.

In Ms. McDaniel's case, the 59-year-old in January abandoned the 4,300-square-foot Loveland, Colo., home she and her late husband built. After her husband's death in July 2008, Ms. McDaniel, who earns about $34,000 a year as a home-health nurse, couldn't maintain the $3,000 monthly payments necessary on her nearly $500,000 interest-only mortgage. So she stopped making them and moved in with an uncle.

Now, she's bracing for the next blow: an Internal Revenue Service form detailing as much as $150,000 in debt canceled by the bank when it took control of the house. The canceled debt is a form of income, says the IRS—meaning she'll owe taxes on it.

"I had no clue this would happen," says Ms. McDaniel, who, with her husband, had refinanced at least three times, including one cash-out loan. That transaction caused her problems because, while canceled debt originally used to buy or build a house can be exempted from tax filings, debt used for other purposes cannot. "I just thought I'd get out from under the house and that would be that," she says.

As the U.S. economy continues struggling with the fallout of the debt-induced housing crisis, millions of homeowners like Ms. McDaniel are discovering that their decision to walk away from a mortgage could result in tax bills running into the thousands or tens of thousands of dollars.

The upshot: anyone weighing whether or not to seek a mortgage modification—or debating whether to abandon a house that is worth less than the mortgage—should consider the tax treatment carefully before making a move. The same holds for any form of consumer debt that a bank ultimately cancels, including credit-card balances or an auto lease.

Federal and state tax laws have long viewed canceled debt as income because consumers who borrow money to buy a house—or who pull money out of their house to buy cars and such—and then don't pay it back "wind up ahead of where they were," says an IRS spokesman.

Thus far this year, Michele Knight, a CPA with a high-end clientele in Keystone, Colo., has had five clients owe taxes tied to houses and another five tied to credit cards and auto leases. "They're calling me in tears and saying, 'What do you mean I owe taxes?'" she says. "I never would have expected it."

Dianne Corsbie, a White Plains, N.Y., financial planner, says about 5% of her 200-client practice owes taxes because of a foreclosure, most tied to investment properties. In Napa, Calif., Duane Carey, owner of a Ranch Tax Service, says every fifth person he sees "comes in angry, holding one of these 1099s."

Overall, the IRS estimates that individual taxpayers will have filed nearly 3.6 million tax returns for 2009 that include income from canceled debt. That's down a bit from 2008, but up 17% from 2007. The numbers include taxes due on primary homes, vacation and rental property, credit cards, auto leases and other canceled debts. The IRS projects the numbers to rise in coming years.

Part of that rise will likely come as the government expands its mortgage-modification program, including a call in March by the Obama administration for banks to reduce principal as a way to help people remain in their homes. That reduction could lead to tax obligations.

At first the government's mortgage-modification program focused on primary mortgages, which are tied to the purchase or construction of a primary residence, and which are eligible for exemption under a 2007 Congressional act aimed at helping homeowners avoid the tax implications of a foreclosure.

That act—the 2007 Mortgage Forgiveness Debt Relief Act—exempts taxpayers from as much as $2 million in forgiven debt. But the debt had to be acquired before Jan. 1, 2009—and had to have been used solely to buy, build or remodel/repair a primary residence.

The government's new, expanded modification programs include short sales, in which a bank agrees to accept as full payment less than the value of the mortgage balance; deed-in-lieu transactions, when a homeowner gives the house to the bank instead of repaying the mortgage; and second mortgages such as home-equity lines of credit.

In many of those instances, say Treasury officials, homeowners used mortgage money to fund everything from tuition and medical bills to vacations and cars and even the down payment on a second home or investment property. That debt, however, isn't eligible for exemption.

Sometimes the tax bills are so high that people can't afford to pay. In such a situation, the IRS will allow taxpayers to apply for an installment-payment plan.

Some homeowners can avoid the taxes completely if they can prove insolvency, in which the total value of debt exceeds total assets. But even that could leave some owing taxes.

IRS rules stipulate that a taxpayer can escape taxes up to the extent of insolvency, meaning that if one's liabilities are $500,000 and assets are $300,000, the $200,000 difference is the extent of the insolvency. But if the person has $250,000 in debt canceled, then $50,000 is taxable income.

"People think their house was underwater, so they're insolvent and can get out of owing taxes," says Arthur Auerbach, a member of the Individual Income Tax Technical Resource Panel at the American Institute of Certified Public Accountants. "But it doesn't work that way."

Printed in The Wall Street Journal, page B8