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Home Foreclosures And Tax Returns

Foreclosure and taxes are two unpleasant topics. Together, they're even worse. Yet as Americans turn to tax returns, a record number will be facing the tax impact of 2010 foreclosures. We're talking, of course, about debt relief income, also called discharge of debt income, cancellation of debt income, or just "COD."

If you owe $500,000 to the bank, but the bank forgives it, it's as if the bank just handed you $500,000. In general, Uncle Sam assumes you've got income when your debt is relieved. See 10 Things About COD Income. That means Uncle Sam wants his cut.

Exception for Home Mortgage. In response to the mortgage crisis, Congress exempted from income up to $2 million (per couple) in mortgage debt on a principal home, forgiven from 2007 through 2012. This exemption applies if:

- You restructure "acquisition" debt on a principal residence–meaning debt you used to buy or improve a principal residence. If you used a home equity loan to buy a boat or play the stock market and the lender forgives that debt, it's not covered;

- You lose your principal residence in a foreclosure (but be careful: You may have income to the extent the canceled debt does not relate to the purchase or improvement of your principal residence); or

- You sell your principal residence in a short sale, where the sales proceeds are less than you owe and the lender writes off the balance.

If your lender writes off some of your mortgage, you must reduce your basis in the residence by the amount of discharged debt not counted as income. (But you don't have to reduce your basis below zero). Whenever you do sell, you can still use the usual tax benefits that apply to sales of homes. In general, you should qualify for excluding up to $250,000 (or $500,000 if you're married).

> **Example.** Zeke and Lilly bought their house for $1,000,000 in 2007, but in 2010 it is worth only $700,000. Unable to make payments on their $900,000 mortgage, they walk away in 2010. The bank sells it and collects $700,000, and forgives the additional $200,000 loan balance.
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> Tax-wise Zeke and Lilly have sold their home at a $300,000 loss, plus triggered $200,000 of COD income. The loss on a personal residence is not deductible (and can't offset the COD income either). The $200,000 of COD income is taxable, but they can elect to exclude it and reduce their basis by the $200,000. The tax result is neutral–so they face no taxes from the foreclosure.

More Examples. As this example shows, you need to go through the numbers and the facts carefully. The IRS has helpful information on its website devoted to foreclosures.

Cautions. This COD relief works only for primary residences (no vacation homes). It doesn't apply to second mortgages or to home equity loans used for anything other than improvements to your principal residence.

Also, the relief isn't automatic. You must file IRS Form 982, "Reduction Of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)." Sophisticated people may be able to handle this, but I suggest professional help.

Bankruptcy and Insolvency. Apart from the special rules for home mortgages, there's a more general exclusion from COD income. If your debt is discharged when you're in bankruptcy as part of a court-approved bankruptcy plan, it isn't income. Again, the amount of the discharged debt reduces certain tax attributes, such as net operating losses or the basis of property. The rules are complicated and Form 982 is required.

Even if you are not in bankruptcy, if you are insolvent when your debt is discharged, there is no tax. Insolvency means your liabilities exceed your assets. To escape tax, your liabilities must exceed your assets by ***more*** than the amount of debt discharged.

IRS Forms 1099. Any government agency, financial institution or credit union forgiving a debt of $600 or more must issue a Form 1099-C to you and send a copy to the IRS. Don't ignore Forms 1099. If you receive one and disagree with the amount shown, write the lender requesting that it issue a corrected Form 1099-C showing the proper amount of canceled debt. If you believe the canceled debt isn't income to you because you're insolvent or for any other reason, you'll need to address this on your return.

For more information, see:

Beware Each Form 1099!

IRS Form 1099 Wars

The Truth About IRS Forms 1099

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