LawTrends

A publication of Eastman & Smith Ltd.

EASTMAN & SMITH LTD.
ATTORNEYS AT LAW

Established 1844

September 2009
volume 7 number 3

Federal Tax Consequences of Home Mortgage Workouts and Foreclosures

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Many families have lost their homes through foreclosure as a result of the current financial crisis. Others have renegotiated their mortgage loans and have reduced the loan amount. This article will discuss some of the federal tax implications that arise out of these transactions.

Foreclosure sales, non-judicial foreclosure sales and transfers by deed in lieu of foreclosure are considered to be taxable sales and any gain that is realized is taxable to the homeowner even if the sale proceeds go to a bank or finance company. The amount realized on a sale or other disposition includes the amount of nonrecourse liability that is not satisfied as a result of the sale or disposition. Although this income arguably arises from the "cancellation of debt," it cannot be excluded under the cancellation of indebtedness exceptions.

Subject to the statutory limits and unless otherwise elected, the amount received from a sale or exchange of property is excluded from income if the property was the taxpayer's principal residence for at least two years in the five year period ending on the date of the sale or exchange. Property must be owned and used by the taxpayer as the taxpayer's principal residence. To establish use, the taxpayer must have occupied the residence. Whether property is used as a taxpayer's principal residence depends on all the facts and circumstances. Generally, the property the taxpayer uses as a residence a majority of the time during the year will be considered his or her principal residence.

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There is nothing in the statute or the related regulations to indicate this exclusion does not apply to the amount realized from unsatisfied nonrecourse debt securing the property. Consequently, a taxpayer, subject to the statutory limit, can exclude income that is realized from the cancellation of a nonrecourse mortgage upon foreclosure from gross income.

In contrast, the amount realized from the sale or disposition of property that secures a recourse liability does not include the amounts that are (or would be if realized and recognized) income from the discharge of indebtedness. As a consequence, the exclusion of gain from the sale or exchange of a principal residence should not apply to any amount realized from the cancellation of the unsatisfied balance of a recourse loan secured by the residence.

A taxpayer generally is required to include in gross income the amount of any cancelled indebtedness. However, income arising from the cancellation of "qualified principal residence indebtedness" is not included in gross income. This exception does not apply if the discharge is on account of services performed for the lender or on account of any other factor not directly related to a decline in value of the residence or the taxpayer's financial condition. Qualified principal residence indebtedness is any debt that was incurred in acquiring, constructing or substantially improving certain categories of property and is secured by the property. It also includes any indebtedness secured by the property resulting from refinancing indebtedness described in the previous sentence, limited to the amount of indebtedness that was outstanding before the debt was refinanced.

For purposes of this exclusion, the term "principal residence" has the same meaning as applies to the exclusion discussed above. Although the sale of a principal residence exclusion can apply to a sale of property that a taxpayer is not currently using as his or herprincipal residence, a residence must be the taxpayer's principal residence at the time the debt is discharged for the qualified principal residence indebtedness exclusion to apply.

A lender that agrees to cancel mortgage indebtedness is required to issue a 1099-C to the taxpayer reporting the amount of the cancelled debt. A taxpayer is required to attach a completed Form 982 to his or her federal income tax return for the year in which the cancellation of indebtedness occurred to claim the exclusion. A taxpayer who is insolvent at the time of the cancellation of debt can exclude an amount no greater than the amount of the taxpayer's insolvency under another provision. So, a taxpayer who cancels or reduces mortgage indebtedness can alternatively elect to exclude income under the insolvency provision.

A taxpayer should carefully analyze the options if both exclusions apply to maximize his or her tax benefits. Eastman & Smith Ltd. will be happy to assist you in analyzing your options if you are in this unfortunate situation.

Mr. Downey is an associate in the Business Section of the Firm with more than 10 years of legal practice in business, corporate, estate planning, probate, real estate, school and tax law. Mr. Downey worked for over five years as a Revenue Officer for the Internal Revenue Service before joining the Firm. He can be reached by calling our Toledo office (419-241-6000).

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