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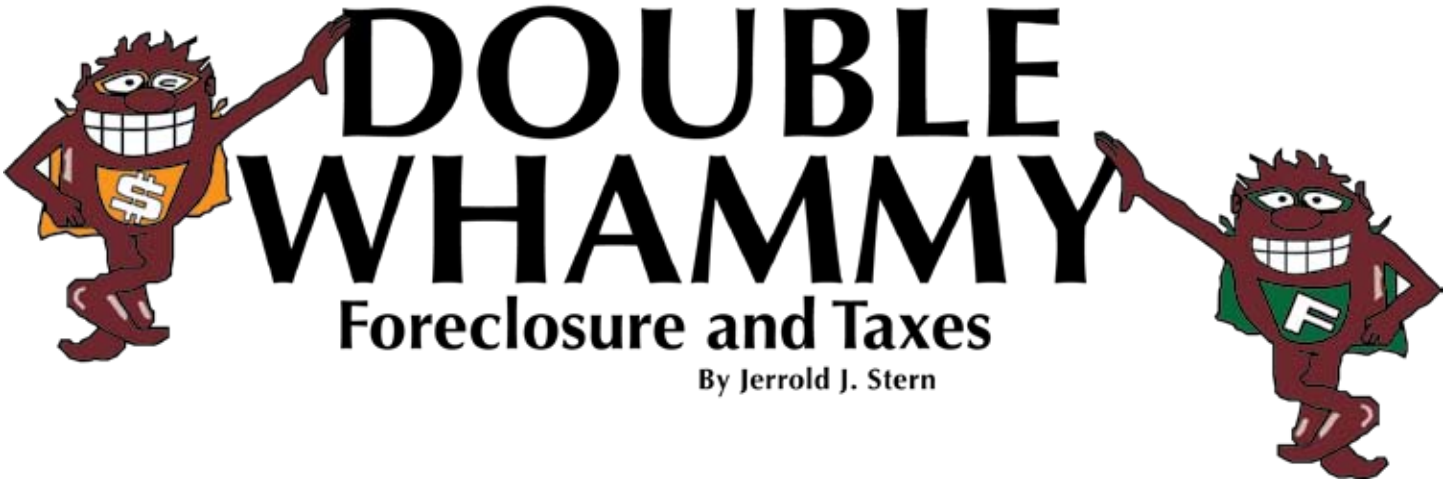

DOUBLE WHAMMY

Foreclosure and Taxes

By Jerrold J. Stern

Foreclosures are making headlines these days, both nationally and in Texas. While income taxes may be the last thing on the minds of homeowners facing foreclosure, there are tax implications to consider.

Two taxes are linked to foreclosure:

- Tax No. 1 is based on ordinary taxable income associated with the cancellation of debt (not applicable with nonrecourse loans), and
- Tax No. 2 is based on taxable gain from disposition of the home (applicable with both recourse and nonrecourse borrowings).

Nonrecourse Loans

On a nonrecourse loan default, the borrower loses possession of the home and title and has no further financial obligation to the lender, even if the mortgage balance exceeds the home's fair market value (FMV). Moreover, the borrower has no ordinary taxable income from the cancellation of the nonrecourse debt, so Tax No. 1 is avoided.

Gain, and potentially Tax No. 2, result from foreclosure in connection with a nonrecourse loan if the adjusted basis of the home (the original cost plus improvements made during the holding period) is less than the loan balance at default. For tax purposes, the transaction is considered a sale, and the loan balance is viewed as the sale price.

Assume Harry cannot make the mortgage payments on his nonrecourse loan, and the lender forecloses. His mortgage balance is $375,000, and the adjusted basis in his home is $100,000. He faces a $275,000 potential gain ($375,000 less $100,000).

If Harry is unmarried and used the home as a principal residence for a total of at least two years during the five-year period ending on the date of the foreclosure, $250,000 of gain from the home sale is excluded from income. If Harry is single, he recognizes a $25,000 long-term capital gain ($275,000 less $250,000), generating Tax No. 2.

The exclusion is $500,000 for married couples filing a joint tax return, so married taxpayers filing a joint tax return would avoid tax entirely in this scenario.

If the property is not a principal residence, the gain exclusion does not apply. The entire gain becomes a taxable long-term capital gain taxed at either 15 percent or 5 percent depending on the taxpayer's other taxable income.

Note that the FMV of the home ($250,000) does not alter the computations when the loan is nonrecourse. However, if the FMV was more than the mortgage balance, the homeowner would be able to sell the home, pay off the mortgage, and avoid foreclosure.

Losses from foreclosures of personal use property are not deductible. If the adjusted basis for Harry's home is raised to $420,000, a $45,000 potential loss results. Tax No. 1 and Tax No. 2 would be avoided because the adjusted basis is greater than the $375,000 loan balance.

Recourse Loans

Most Texas home mortgages are recourse loans. While recourse loans may have collateral (such as vehicles, machinery, equipment or real estate), the borrower is obligated to pay the full loan balance if the collateral is taken by the lender through loan default and the property's FMV is less than the loan balance. If the borrower does not pay the entire recourse debt with property and cash, the amount forgiven is considered ordinary taxable income, giving rise to Tax No. 1. Exceptions to this rule follow.

The tax character of the income is ordinary regardless of whether the asset is investment property, personal use property or business property. Ordinary income can be taxed at rates as high as 35 percent depending on the amount of income and taxpayer's income from other sources.

The lender is required to issue IRS Form 1099-C to the borrower and submit a copy to the IRS. The form states the amount of debt cancelled and the FMV of the property taken by the lender.

If Harry's mortgage loan is recourse, the tax implications are significantly worse. Tax No. 1 would result from $125,000 ($375,000 loan balance less $250,000 foreclosed property FMV) recognized as ordinary income and taxable at ordinary tax rates. Again, ordinary tax rates apply on recourse debt cancellation regardless of whether the underlying asset is a capital asset.

Tax No. 2 must also be paid because of the $150,000 gain ($250,000 FMV, which is treated as the sales price, less $100,000 adjusted basis). If the home is a principal residence, Tax No. 2 can be avoided through the $250,000/$500,000 gain exclusion.

Let's say Harry has a recourse loan and an adjusted basis of $420,000. Even though the adjusted basis is higher than both the loan balance ($375,000) and the property FMV ($250,000), Harry has to recognize $125,000 taxable ordinary income because the loan balance exceeds the $250,000 FMV. The $170,000 loss potential ($420,000 adjusted basis less $250,000 FMV) may offset the gain depending on whether the asset is business property, investment property or a personal use asset.

Some exceptions may allow taxpayers to avoid Tax No. 1 on recourse borrowings:

- *Gift:* If the creditor is a relative, he or she may forgive the portion of the loan balance not satisfied by collateral.
- *Bankruptcy:* Debts discharged through bankruptcy are not considered taxable income.
- *Insolvency:* If the taxpayer is insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable. Insolvency exists when the taxpayer's total debts exceed the FMV of total assets.
- *Qualified farm debts:* If the debt is incurred for farming, more than half of the taxpayer's income in the three preceding years was from farming, and the loan was owed to a person or agency regularly engaged in lending, the cancelled debt is generally not considered taxable income.

The tax implications of foreclosure are complex, as are procedures for determining insolvency and rules applicable to farmers. Consultation with a tax accountant or tax attorney is recommended.

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THE TAKEAWAY

Foreclosure has two possible tax consequences. Tax may be due as ordinary taxable income associated with the cancellation of debt or as taxable gain from the disposition of the asset.

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Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: JP Beato III, p. 1.