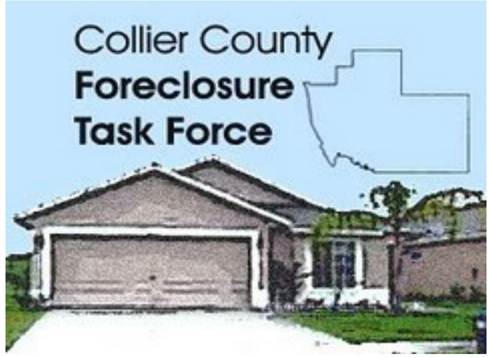

HOW THE TAX LAW CAN MAKE A BAD SITUATION WORSE

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This Article will discuss how foreclosure or a short sale can get worse.

Before applying this information to any individual situation you should consult your tax and legal advisor.

When a person is faced with foreclosure most people do not think of the tax implications. The tax effects have often resulted in as large a financial calamity as the foreclosure itself. Under the Tax Code, forgiveness of indebtedness is income. There are exceptions to this. The first exception is insolvency. The government does not wish to impose this added burden on someone who is in bankruptcy or, while not filed for bankruptcy, is insolvent. Whether or not someone is insolvent, they need to check with their advisor to see if this exception applies even if they file for bankruptcy. There are three (3) other exceptions that are available: 1) is qualified farm indebtedness; 2) is qualified business real property indebtedness. But these two (2) items are not as widely applicable as the other exception that will be discussed below and have many technical requirements therefore they will not be fully addressed in this Article.

The last general exception is qualified principal residence indebtedness. This is new to the Internal Revenue Code and was only passed in response to the massive amount of foreclosures. This exception only applies to forgiveness of indebtedness income that occurs during the years 2007 through 2012 and it also only applies to acquisition indebtedness. This is defined as indebtedness that was used to acquire, construct or improve the residence and it has a limit of $2,000,000.00 and $1,000,000.00 for a married taxpayer filing a separate return. Refinancing is covered only to the above limits, thus if someone refinanced their home and their original home had acquisition indebtedness of $600,000.00; construction indebtedness of $100,000.00 and improvement of indebtedness of $100,000.00 but that taxpayer had taken out an additional $100,000.00 just to spend on other items or to consolidate car or credit card debt. This individual, if they were foreclosed or had a short sale and was forgiven of this indebtedness they would have income of $100,000.00, if they were not insolvent. This can result in a substantial tax bill.

The next matter that needs to be addressed is what is forgiveness of indebtedness and when does it occur? If a short sale is done and the Lender agrees to waive deficiency then forgiveness of indebtedness income has occurred. If a Lender forecloses and decides not to pursue the deficiency, then forgiveness of indebtedness income has occurred.

The question sometimes it arises when a Lender does a short sale or a foreclosure and doesn't forgive the debt but doesn't pursue right away or ever. In the first instance of the bank and not pursuing the indebtedness right away, then forgiveness of indebtedness income has probably not occurred until the Lender decides to write off the debt and not pursue it.

The question that is being raised more and more often since Lenders and their attorneys are so disorganized and cannot keep track of many of the matters that they are in charge of effectively is what happens when the foreclosure or short sale is done and the file is simply forgotten by the institution. Many tax experts believe that forgiveness of indebtedness income will not occur in this instance. Others think it occurs when the statute of limitation runs on the Lenders ability to collect it.

Lenders will often send a Form 1099 when they believe that forgiveness of indebtedness income has occurred and when this happens, the individual must report this matter on their tax return and try to find an exception from paying tax on the forgiveness of indebtedness or must pay the tax.

Failure to deal with a 1099 on one's tax return for the year in question can subject a taxpayer to substantial penalties interest and other matters.

The largest problem in this area involves persons who took a lot of cash out of their homes for matters other than their house, rental properties, investment properties, or flipped properties that the taxpayer got stuck with when the market collapsed.

The only exception to these types of matters is either that taxpayer qualifies for the bankruptcy or non-bankruptcy and insolvency exception or the Lender does not forgive the deficiency. In the latter case, as pointed out above, this may either turn into a substantial judgment from the Lender when they pursue the deficiency or may result in forgiveness of indebtedness income, when the Lender eventually writes it off and forgives it.

This article is one of a series authored by members of the Collier County Foreclosure Task Force, a grass roots pro bono initiative launched in 2008 by Legal Aid Service of Collier County and the Collier County Bar Association. The Foreclosure Task Force (FTF) was formed to promote foreclosure prevention through education and intervention. The FTF has assisted local homeowners through free public workshops and legal clinics, and via a website it created - www.collierFTF.com.