Cancelled Debt Remains Issue for Homeowners

Let's Talk Tax

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The housing crisis may have dropped from the headlines in recent months. Unfortunately, however, the crisis remains a reality - **a potentially taxable reality** – for millions of American homeowners.

According to a study by Realty Trac, 17% of residential properties in the United States with a mortgage remained "seriously underwater" (also called *negative equity*) as of March 31, 2014. To be considered *seriously underwater* the mortgage amount(s) on a property must be at least 25% higher than the property's current fair market value.

Local underwater statistics also continue to remain much higher than the national average. According to Zillow's negative equity map (which ranks owner equity by zip code and is available at *Zillow.com*), approximately 27% of mortgaged homes in the Martinsburg and Charles Town areas remained underwater as of the June 30, 2014. These discouraging statistics place much of the region among the 10% of zip codes in the United States experiencing the highest negative-equity rates as a percentage of mortgaged homes.

What does this mean for those underwater? Although housing prices have increased in recent years, it remains highly probable that those who purchased or refinanced (1) a home, (2) a second home, or (3) a rental/investment/business property between 2003 and 2007 still owe more on that property than it is worth. Those in this unfortunate position face one of three choices if they choose to leave the property:

1. Abandon the property,
2. Lose the property to foreclosure, or
3. Sell the property *short*.

A "short sale" occurs when the mortgage holder allows the property owner to sell at a price less than the balance owed on the mortgage. **Abandonment** occurs when the owner leaves the property and the mortgagee takes possession. Generally, the property is foreclosed upon later. **Foreclosures** (and Deeds in Lieu) occur when the mortgagee takes legal title to a property.

Owners who attempt to *short sell* their homes have three more choices to consider regarding their mortgage(s):

1) Pay off the mortgage balance,

2) Refinance the balance with another loan, or

3) Ask the lender to agree to cancel all or a portion of the remaining debt.

For many debtors, particularly those having a difficult time making their current mortgage payments, paying off the loan balance or refinancing the balance with another debt will prove financially unrealistic. As a result, many owners ask the lender to cancel the remaining debt.

Be Aware: If the lender cancels the debt – whether the result of short sale, abandonment or foreclosure - the property owner may owe income tax on the debt that is cancelled.

Taxable Consequences: When a property is sold short, abandoned, or foreclosed upon, and debt is cancelled, two potentially taxable events occur.

1. A sale has occurred. A property that is sold short is generally sold in a normal sales transaction although the sales price is less than the amount owed on the mortgage. When a property is abandoned or foreclosed upon there is no contractual sale but the property is, in effect, sold to its creditors. These "sales" may result in a capital gain or loss that may or may not be taxable depending on the circumstances of the sale (discussed below).

2. Short sales and foreclosures may also result in taxable income if any portion of the mortgage is forgiven (unless a specific exception applies – discussed later). This income is called Cancellation of Debt Income.

Calculating Capital Gain/Loss: In order to calculate the taxable gain or loss from a short sale or foreclosure, the property's sales price must be determined.

- **For a short sale** this is relatively easy. The sales price is the contract price. Determining the sales price of a foreclosed property is a bit more complex.
- **The "sales price" of a foreclosure** will depend on whether the property's mortgage is **"recourse"** or "**nonrecourse.**" Recourse loans are loans the borrower remains personally liable for after foreclosure. Nearly all mortgages in WV, VA, MD and PA are recourse mortgages. For recourse loans, the "sales price" is the lesser of the loan amount or the fair market value of the property.

To Calculate Capital Gain or Loss: Once "sales price" is determined, the capital gain or loss is calculated by subtracting the owner's investment, called **"basis,"** from the sales price. Generally, the owner's basis represents the owner's investment in the property. This includes (but is not limited to) original purchase price plus capital improvements (such as additions and extensive remodeling). If the difference between sales price and basis is positive, there is capital gain; if negative, a capital loss.

It may be helpful to keep the following points in mind regarding this gain or loss:

- If there is a capital gain and the owner lived in the property as their primary residence for two of the past five years, the homeowner may be able to exclude all or a portion of the gain from income.
- A capital loss on business or investment property may be deductible.
- Losses on personal-use property – such as a primary residence - are not tax deductible.

Cancellation of Debt Income (CODI): Cancellation of debt income can occur when the amount of recourse debt exceeds the property's fair market value (or sales price if the property is sold) and the lender forgives the remaining debt. **Note: This cancelled debt will constitute taxable income unless one or more applies.** These exclusions include (but are not limited to):

1. Debts discharged in bankruptcy,
2. Insolvency immediately before the debt was forgiven,
3. Qualified Farm Debt,
4. Qualified Real Property Business Debt, and
5. Qualified Principal Residence Indebtedness.

The Bankruptcy exclusion is fairly straight forward but the debt must be discharged in the bankruptcy – before it is cancelled. Proving insolvency, however, requires additional calculations to determine whether the debtor had a negative net worth just prior to the debt cancellation. The Qualified Farm Debt Exclusion requires the property owner to have earned the majority of their income from farming for the previous three years and the debt to be directly related to the business of farming.

The Qualified Real Business Property and Qualified Principle Residence Indebtedness Exclusion apply only to "qualified acquisition debt:" (including refinanced acquisition debt). **Acquisition debt** is debt used to acquire, construct or substantially improve the property. Any debt forgiven that is not qualified acquisition debt will be taxable unless another exemption applies.

Note: As of the time of this writing, although legislation has been introduced to extend the Qualified Principal Residence Indebtedness Exclusion, it has NOT been extended to include debt forgiven in 2014.

CAUTION: Warning and Take Away –The taxation and canceled debt exclusions related to the sale or loss of an under-water property are highly complex and also often require what is called "Reduction of Tax Attributes." This or any article can only scratch the surface. If you should find yourself facing the sale or loss of an underwater-property please seek tax advice before moving forward. As always, this article is for informational purposes only and does not constitute tax advice. If we can be of any assistance with this or any tax or business issue, please feel to contact our office at (304) 267-2594.

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