



The Default News™

Part 1 — Tax Implications when
Defaulting on a primary residence

Recently, with the surge of defaults, foreclosures, and short sales many taxpayers are walking away from their primary residence or investment property. Sadly enough, there are tax implications involved which should be considered.

Tax implications on a mortgage default associated with a primary residence is totally different from those associated with an investment property. This article is part one of a two part series focusing on tax implications when defaulting on your primary residence.

On December 21, 2007, legislation changed the way a foreclosure or short sale is handled for tax purposes on a primary residence. Prior to this law, when a taxpayer foreclosed on their primary residence they report additional ordinary income on their tax return in the year of foreclosure, and that ordinary income was based on the property's fair market value (FMV), which was determined by how much the bank sold the property for or by the prevailing appraised value.



The difference between the FMV and the amount the taxpayer owed on the home would be considered "cancellation of debt".

For example:

- The homeowner's primary residence loan balance is \$300,000.
- They short sale the property for \$250,000.
- \$50,000 is still owed to the bank.
- Under the old law the bank would issue a 1099-C reporting \$50,000 of income to the taxpayer as "debt cancellation" (a.k.a. additional ordinary income), and they'd face state and federal tax implications.

As a result of the new law, if a taxpayer's primary residence is foreclosed or sold thru a short sale in tax years 2007— 2009, the law will allow the homeowner to exclude the "debt cancellation" from ordinary income. This does not mean a bank will not still issue a 1099-C (debt cancellation) or a 1099-A (Abandonment).

***Income tax has made more
liars out of the American
people than golf.***

~ Will Rogers

However, what one needs to know is how to treat either a 1099-C (debt cancellation) or a 1099-A (Abandonment) for tax purposes. Plus, people need to realize that the new law is a huge benefit to homeowners who need to realign themselves financially.

Tax Tip #1: Take Advantage Of The New Tax Law



To take advantage of this law, the amount of the “debt cancellation” cannot be more than 2 million dollars if married filing a joint return or 1 million dollars if married filing separately. The debt on the home has to be the original acquisition debt or money used to improve the residence.

With any law, there are always exclusions and other considerations the taxpayer or homeowner must take into consideration, for example:

- If the taxpayer paid PMI, their loan is insured and there should not be any tax implications; thus, the need to report any additional income is alleviated.
- If the homeowner is considered to be insolvent or have more liabilities than the FMV of all their assets, the debt cancellation income need not be reported.
- It is also important to know if you have a recourse or non-recourse loan.
 - Non-recourse loans is the original loan on the home (no refinancing), and they prevents the bank from coming after you for the amount of debt owed in the event of a short sale or foreclosure.

Many issues come into play with foreclosures and short sale, but rest assured that the latest tax law was enacted to help taxpayers who genuinely need help.

Lenders may not implement the new law properly, so understand your unique situation. With the idiosyncrasies of foreclosure and taxes, it is important to seek professional tax advice to ensure your transaction is reported correctly and to confirm you are taking advantage of the new tax laws affecting a defaulted primary residence.



Karla Dennis is a licensed Enrolled Agent. She is approved by the U.S. Treasury Department to prepare taxes in all 50 states. She holds a Masters of Science Degree in Taxation and a Bachelor of Science Degree in Business Administration.

Ms. Dennis is the President and Founder of Cohesive Tax— a professional tax firm that specializes in complex tax situations, tax preparation and solving tax issues.

To learn more about Ms. Dennis, visit www.CohesiveTax.com.

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