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Loan forgiven, not forgotten

By Barbara E. Hernandez
CONTRA COSTA TIMES

Homeowners should know that although debt can be forgiven, it's never forgotten.

When a short sale, deed-in-lieu agreement or foreclosure occurs and a residential lender loses money on a loan, the lender will most likely file the loss with the Internal Revenue Service, and the former homeowner may end up owing thousands of dollars in taxable income.

It comes in the form of a 1099-C, or Cancellation of Debt. According to the IRS, the cancellation or forgiveness of a debt is the same as if the lender handed the homeowner cash and shook hands.

"That's probably where we see kind of the biggest surprise on the part of our clients," said Jackie Pearlman, senior tax research coordinator for H&R Block's headquarters in Kansas City. "Not only are they not aware it existed but are very surprised to understand that it's income. The concept is really alien to many people."

But being sent a 1099-C that says a former homeowner owes \$50,000 doesn't mean all is lost, experts say.

Bill Purdy, a Soquel-based attorney in Santa Cruz County who represents clients with home lending problems and foreclosures, said a 1099-C doesn't always mean that the former homeowner has any added taxable income.

"We all know intuitively that if you borrow money you don't have the income," Purdy said. "If you don't have to pay it back, it can become income."

But if the lender takes a loss selling a property, let's say \$100,000, the company will file with the IRS, and the client will receive a 1099-C for the amount.

That's where the controversy starts, Purdy said. Capital gains exemptions still apply, and homeowners are allowed a \$250,000 gain for singles or \$500,000 for couples even if their home is in foreclosure.

"There has been a sale. It just hasn't been the sale you wanted," he said.

Purdy said that in many situations the debt won't be considered taxable income, but it can when a homeowner has enormous debt on the home. Homeowners with two mortgages and home equity loans may find that the debt exceeds the "basis," or what the homeowner paid into it.

If the debt is more than the home's basis and it exceeds the capital gains exemption, the former homeowner may be able to claim insolvency. Purdy said former homeowners should talk to their accountants immediately.

Pearlman said it may not be taxable if a taxpayer is insolvent or bankrupt and that can be documented to the satisfaction of the IRS.

"My very, very best advice is to come to your tax professional and figure out what you owe," she said. "Let us help you figure out what your situation really is."

Purdy said many people try to ignore the problem.

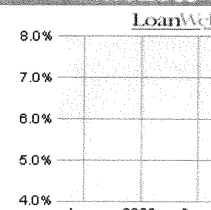
"The problem is that people do nothing," he said. "They get these, and they freeze like deer in headlights."

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But none of this matters to the IRS, which knows only that a 1099-C was distributed as taxable income.

"They will assume it's taxable until informed otherwise," he said. "And you don't want to wait for that notice in the mail. You want it resolved beforehand."

According to IRS Publication 594, the agency can put a lien on or legally seize property, including bank accounts, to pay tax debts.

Adarsh Sangani, director of residential lending for Fremont Bank, said his bank doesn't issue many 1099-Cs to its customers. "Only if a customer doesn't respond to collection calls, a letter and a collection agency," he said. "And we normally give our collection agencies a year to collect."

Sangani said homeowners defaulting on mortgages aren't an issue for the bank.

"The majority of our loans are done with 20 percent down," he said. "We're an A-paper lender. ... If we were subprime lenders, there would probably be more."

He said the bank is willing to work with homeowners and create special repayment plans or give three-month extensions if problems arise.

"Our goal is not to send a notice of default," he said.

Washington Mutual and Countrywide did not respond to requests for comment.

Jason Menke, a spokesman for Wells Fargo, wrote in an e-mail to the Times, "At this time, we're not able to provide information surrounding foreclosure-related trends, so we'll have to decline your offer to comment on what we're seeing within our mortgage portfolio."

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