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ACCOUNTING & AUDIT

How to Advise Distressed Homeowners in a Year of Tax Uncertainty

In recent years, accounting and tax professionals have become experts at advising their clients about the tax consequences of foreclosures, short sales, loan modifications and walk-aways. In fact, you may have assisted so many clients on these transactions in the last seven years that what used to be a challenge may now seem like "old hat."

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But this year there are new challenges. A key tax relief provision, the Qualified Principal Residence Indebtedness (QPRI) exclusion, has expired, and while many politicians and pundits seem certain it will be extended, there is no guarantee.

When a lender cancels or forgives debt, normally the amount forgiven is considered taxable income. From 2007 through 2013, the QPRI exclusion allowed taxpayers who lost their homes, or sold them for less than they owed, to exclude the forgiven debt from income up to certain limits. To qualify, the debt must have been used **only** to purchase, build or improve their homes. The provision brought welcome relief to millions of financially distressed American taxpayers, saving many from financial ruin.

This year's uncertainty makes advising clients more complicated. Even if you feel almost certain that the provision will be extended, your clients may be at high risk if it fails to happen, or if the taxable event occurs before the law is passed and it is not made retroactive. Without the QPRI exclusion, a foreclosure, loan modification or short sale could lead to a potentially devastating tax bill for certain financially challenged clients, depending on the type of debt involved and the laws of your particular state.

How will you guide your clients in making what may be one of the most important financial decisions of their lives? Here are some important tips and reminders to help you navigate this minefield, one of the most complex areas of the tax code.

Know the character of the debt

> The character of the debt determines the tax consequences that are realized when it is cancelled. *Recourse* debt is debt for which the borrower is personally liable, which means the lender has the right to pursue a legal judgment and go after the borrower's other assets that are not secured by the loan. When recourse debt is cancelled or discharged, the amount of forgiven debt is income on the return unless an exclusion or exception applies. But when the sale of *nonrecourse* debt loan collateral comes up short, the borrower owes nothing and there is no cancellation of debt income.
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> Foreclosures, short sales and abandonments are dispositions. When a loan is recourse, the disposition transaction includes both the sale and the cancelled debt components. The amount of debt which exceeds the fair market value of the property is the cancellation of debt income. When the debt is nonrecourse, on the other hand, the entire amount of the unpaid debt is considered to be proceeds from the sale, and gain, if any, may be excluded under IRC Section 121 if the borrower is eligible. Any losses on the sale of a primary residence are nondeductible personal losses.

Check in with the laws of your state

> Twelve states, generally known as the nonrecourse states, by statute require the home to be the collateral on the first purchase mortgage, and their anti-deficiency laws prevent pursuing the borrower after foreclosure or short sale. In addition, many states have enacted new legislation in response to the mortgage crisis. For example, California's anti-deficiency laws were expanded in 2011 to include short sales. Now a lender that agrees to a short sale is no longer allowed to pursue a

deficiency judgment against the debtor. Also, per a 2013 letter from the IRS Chief Counsel, the IRS will treat such loans as nonrecourse with no cancellation of debt income resulting. The laws might have changed since the last time you handled a COD situation or maybe there's a new bill under consideration.

Explore other ways to exclude the cancelled debt from income

If your client was foreclosed upon, or is considering loan modification or short sale, carefully evaluate other ways they may be able to exclude the income. For example, do they qualify for the insolvency exclusion? Taxpayers are allowed to exclude cancelled debt from income to the extent that they are "insolvent" immediately before the debt cancellation. They are considered to be insolvent to the extent that the total of all of their liabilities exceeds the fair market value of all of their assets immediately before the cancellation.

As a last resort, it may be beneficial for certain clients to at least explore the idea of bankruptcy. This is a decision that should not be made lightly, as their credit will be damaged for years and the effects of bankruptcy are far-reaching. A good bankruptcy attorney should be consulted to consider all possible consequences.

While all signs point to the worst of the mortgage crisis being over, two mid-year studies released in July by RealtyTrac reported 613,874 U.S. property foreclosure filings and more than 9.1 million residential properties seriously underwater. This is a clear indicator that the fallout from the bursting of the housing bubble will continue for the foreseeable future – and that your clients will be seeking your advice about their property transactions.

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