NATION'S HOUSING

Canceled debt tax test has a payoff

Some people who had foreclosures, loan modifications and short sales may qualify for exemption.

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REPORTING FROM WASHINGTON

With hundreds of thousands of homeowners having negotiated loan modifications or short sales or been foreclosed upon during the last year, the Internal Revenue Service has issued fresh guidance on how to handle canceled mortgage debt in the upcoming tax season.

It's a huge issue, widely misunderstood by consumers and involves potentially billions of dollars of tax liability.

Usually, when a creditor cancels debts, such as unpaid balances on student loans or credit cards, the forgiven amounts are treated as ordinary, taxable income by the Internal Revenue Code.

But under a special exemption adopted by Congress covering distressed home mortgages, many owners can escape the ultimate double whammy: getting hit with extra taxes because your mortgage went seriously delinquent or you lost your house.

In its latest guidance, the IRS focuses on several key points that owners — and former owners — need to know.

Tops on the list: If a lender wrote off a portion of your mortgage debt, you don't automatically qualify for special tax treatment. To the contrary, there are essential tests you need to pass to qualify: The debt your lender canceled must have been used by you "to buy, build or substantially improve your principal residence."

There's a lot packed into these words, so it's important to parse them carefully. Start with the house itself. It can't be your second home, an investment condo, a weekend retreat or a seasonal home you occupy for less than half the year. It can only be your main residence, and you need documents to prove it.

Next, the unpaid mortgage balance your lender canceled as part of a modification, short sale or foreclosure cannot have been used for something other than acquiring or constructing the house or making capital improvements to it.

Refinanced mortgage debt used for tuition, vacations, buying cars or paying off credit card bills won't make the grade.

The IRS offers a hypothetical example of how borrowers can mess up their chances for tax relief. A taxpayer took out a first mortgage of $800,000 when he bought his home years ago. Thanks to strong appreciation, the house was soon worth $1 million and the owner refinanced the mortgage to $850,000. The loan balance at the time of the refi was down to $740,000, and the owner used the $110,000 in cash-out proceeds to buy a new car and pay off credit card debts.

Bad move. A year or two later — presumably well into the recession and housing bust — the home value had plunged to between $700,000 and $750,000.

The owner then persuaded his bank to allow a short sale for $735,000 and to cancel the remaining $115,000 of unpaid debt.

Does the owner get tax relief on the full $115,000 under Congress' special exemption? No way, according to the IRS. He escapes income taxes on just $5,000 of the $115,000, because he spent the other $110,000 on a car and credit card balances — neither of which counts as "qualified principal residence" debt.

Greg A. Rosica, a tax partner with accounting giant Ernst & Young, said misunderstandings of the rules about mortgage debt forgiveness are common. People often don't know that the money they used for vacations and other purposes do not qualify under IRS rules, he said.

Taxpayers who walk away from their houses may be liable for taxes, Rosica said, if at some point the property "no longer was their primary residence" — say they rented it out after their last payment and before the foreclosure — effectively converting the house into rental property, not their principal home.

The IRS highlighted some other key points in its guidance:

- Mortgage cancellation relief is capped at $2 million for single and married taxpayers, $1 million for married owners filing separately.
- Anyone who has had mortgage debt canceled as part of a loan modification or foreclosure should go to IRS.gov and download Form 982 and IRS Publication 4681 for additional filing details. Or they can call (800) TAX-FORM to request copies. Lenders who write off unpaid mortgage balances typically provide borrowers with a year-end IRS form 1099-C cancellation of debt statement, including the amount of the loan forgiven and the fair market value of the property.

If you have had mortgage debt canceled but haven't received a 1099-C from your lender, request it to avoid federal tax hassles.

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WEEKLY MORTGAGE RATES

Survey of 20 Orange and L.A. County lenders as of 3/9/2010

Loans to $417,000	Week ended 3/9/2011	Week ended 3/2/2011	Week ended 9/8/2010
30-year fixed	4.97%+.32pt	4.96%+.41pt	4.49%+.20pt
15-year fixed	4.29%+.27pt	4.28%+.31pt	4.08%+.24pt
$417,000 and up			
30-year fixed	5.48%+.42pt	5.50%+.50pt	5.21%+.33pt
15-year fixed	4.94%+.35pt	4.81%+.54pt	4.96%+.29pt
Home equity lines	5.73%	5.73%	5.39%
Home equity loans	8.24%	8.24%	7.97%
6-month LIBOR	.46%	.46%	.49%
1-year Treasury	.26%	.27%	.25%
6-month Treasury	.17%	.16%	.19%
6-month CD	.38%	.38%	.38%
Prime rate	3.25%	3.25%	3.25%
11th District cost of funds	**1/2011**	**12/2010**	**7/2010**
	1.484%	1.508%	1.753%

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