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Tax hit if you lose house

FORECLOSURES CREATE CONFUSION

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Desperate to avoid foreclosure, Maria Carmona and her husband, Victor, put their San Jose home up for sale in November. Despite their efforts, the foreclosure happened last month.

Now, on top of everything else - from losing their home to growing credit card debt - they're wondering how this ordeal will affect their tax bill.

The couple's tax adviser could only tell them they'd probably owe some state income tax on the total mortgage debt "canceled" by the foreclosure.

Then again, they might not, depending on a bill pending in the Legislature.

Like many others caught in the housing market slump and credit crisis, the Carmonas are confused.

"It's going to hit us in 2009," said Carmona, who works for the Santa Clara County Public Health Department.

The answer may be a year away for the Carmonas, but tax preparers already are grappling with the tax consequences of foreclosure as they work toward Tuesday's tax filing deadline.

"Even among the tax professionals I think there's some confusion," said Sharon Kreider, a certified public accountant in Sunnyvale. "There are a lot of people in the tax business who haven't seen foreclosures or cancellation of debt who are going to see it for the first time in 2007."

Santa Clara County recorded 1,439 foreclosures in 2007, but that number is likely to rise in 2008. It's estimated that more than 2,500 homes on the market here are "distress" sales - which usually means they are bank-owned properties or "short sales." A short sale is when an owner tries to sell his or her home for less than is owed on the mortgage.

Most of the 2,500 owners will have some mortgage debt canceled after a foreclosure or short sale, and for some there will be tax consequences.

Until recently, if a homeowner owed $500,000 on his mortgage, for example, and with his lender' s approval sold his home for $400,000, the $100,000 in debt that the lender "forgave" or "canceled" was treated

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as taxable income in most cases. But the Mortgage Forgiveness Debt Relief Act of 2007, a federal law passed in December, changed that for federal income tax purposes.

Under the new law, canceled mortgage debt is not considered taxable income if:

• The mortgage was for the borrower's primary residence;

• The mortgage was used to purchase, build or "substantially improve" that property;

• The mortgage debt cancellation occurred in 2007, 2008 or 2009.

• The balance on the mortgage was less than $2 million.

Borrowers with refinanced loans on their primary residences can get the same tax relief. But that's only if their new loan was not a "cash out" refinance in which they borrowed against their equity to do something other than improve or remodel the home, Kreider said.

"If I borrowed from the house and used the money for a new car or to pay college tuition . . . when that's canceled, that's not forgiven by this new law," she said.

While the new federal law gives a break to those homeowners who undergo foreclosure or a short sale, California law still treats most canceled mortgage debt as taxable income. However, that could change soon if California Senate Bill 1055 passes. The proposed legislation would bring the state tax code into line with the changes enacted at the federal level.

"This is complicated. It's not simple," said Manuel Alvarez, general manager of Latino Taxes, which has six Bay Area offices, including one in San Jose. He estimates that about 1 percent of his company's nearly 3,000 clients had a short sale or foreclosure in 2007. Many of those with foreclosures borrowed heavily to invest in multiple properties during the boom.

But people whose investment properties are foreclosed upon or short-sold generally will owe tax on their forgiven mortgage debt. The only ways they can avoid that are through filing bankruptcy, or by proving they were "insolvent" at the time of the debt cancellation, Alvarez said. Insolvency is when a person's financial liabilities are greater than his assets.

James "Ike" Shulman, a bankruptcy attorney in San Jose, said "it's a very complex analysis" to determine whether bankruptcy can help a taxpayer's situation if he or she is facing foreclosure, especially when multiple properties are involved.

Some will owe tax on the debt forgiven and some would benefit from bankruptcy, while others would not. He recommends those facing foreclosure or short sale seek advice from a bankruptcy attorney.

"To talk about foreclosure and not have bankruptcy in the repertoire of solutions is missing a lot of the options people have to get back on track," he said.

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