

Tax Consequences of Home Mortgage Foreclosure

Many Americans are falling behind in their mortgage payments, in large part due to adjustable rate mortgages (ARMs) that have reset to higher rates. The delinquency rate for mortgage borrowers continues to increase, and a record number of homes are entering the foreclosure process.

The tax consequences that accompany a home mortgage foreclosure can further weaken an already tenuous financial condition. When a lender forgives any portion of a mortgage loan, taxable "cancellation of debt" income generally results. However, there are several instances where cancellation of debt income is not taxable, the most common involving bankruptcy, insolvency, qualifying farm debts, and non-recourse loans.

Another component of the home foreclosure scenario is capital gain income. Because a home foreclosure is treated like a sale, capital gain is recognized if the property's fair market value exceeds its basis. However, a taxpayer may exclude up to \$250,000 (\$500,000 for joint filers) of this gain if the property was owned and used as a principal residence for two of the previous five years.

A taxpayer that owes additional tax due to a home mortgage foreclosure can request a payment agreement with the IRS, or may qualify to enter into an offer-in-compromise that will provide a partial abatement of the tax.

Reproduced with permission from CCH's Client Letter, published and copyrighted by CCH Incorporated, 2700 Lake Cook Road, Riverwoods, IL 60015.