Homeowners Facing Foreclosure May Feel Forced into Bankruptcy in 2013 - But Other Options Exist

December 18, 2012 - There is a very big change coming to tax laws in January that will impact any homeowner who is facing foreclosure or a short sale after the first of the year. We've made mention of this in several of the articles that we've done on the fiscal cliff. But we haven't just focused on this one item. Unless congress makes a change to tax laws going into next year, anyone going through a foreclosure after December 31st is likely to be hit with a very big tax bill. And the only way to get out of that bill could be bankruptcy.

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When housing markets were collapsing in 2007, Congress passed a law called the Mortgage Forgiveness Debt Relief Act. The goal of the law was to help struggling taxpayers who had already lost their homes by relieving them of any tax burden that they would face as a result of their foreclosure.

Now, you may think it is odd that someone who has lost their home could face taxes as a result of that loss. After all, you don't normally get taxed on money that you have lost. But in this case, yes the borrower lost their home to the bank. But at some point, the borrower also borrowed money from the bank to purchase the home. And since that borrowed money is not going to be repaid to the bank, the IRS now counts it as regular income.

The same story holds true for people selling their home in a short sale. In this case, the borrower purchased a home and then sells it to someone else for less than they owe to the bank. The difference between what they borrowed and what the bank was actually able to get back out of the short sale is now considered income to the borrower. Never mind the fact that you never actually put your hands on the money. You now owe taxes on it. Or rather, without the Mortgage Forgiveness Debt Relief Act you would owe taxes on it.

The 2007 law gave anyone facing a foreclosure or a short sale relief from this tax burden. The original law covered tax years from 2007 through 2009. In 2008, Congress extended the law through 2011 and then last year, through the end of 2012. Because of that, you may think that it will be extended again for 2013. And it may be but, at least right now, that's a big question mark.

The act is currently caught up in negotiations over the fiscal cliff. And even if an agreement on the fiscal cliff is reached, there is absolutely no assurance that the Mortgage Forgiveness Debt Relief Act will survive the negotiations. There are a number of reasons for this. The three largest reasons are that 1) Congress is talking about changes to the tax law that would eliminate or limit many tax deductions including some having to do with home ownership, 2) this particular act has been abused by some homeowners and, 3) part of the fiscal cliff negotiations include measures to raise revenue.

The bottom line here is that nobody should count on the law being renewed until it actually is. So for purposes of our discussion here, we're going to assume that it won't be renewed. So what does that mean for people in this situation?

First of all, since we are in the holiday season many banks have announced that they will not be doing any more foreclosures in 2012. In most years, that sounds like they are trying to help struggling homeowner get through the season. This year, it could be the worst thing they could do. Anyone who knows that they are going to be foreclosed on already, and who is prepared to move now, may want to consider talking to their bank about completing the foreclosure process before the end of the year. That may not be possible but it is a question worth asking.

Anyone not able to move should be talking to an accountant about what next year's changes mean for tax planning purposes.

If you do find yourself in the position of facing a massive tax bill next year due to a short sale or foreclosure, there are several options available. The first one should be to speak directly with the IRS.

The IRS does have a variety of programs available to taxpayers. If you truly have a hardship, you may be able to negotiate a smaller overall payment with them. If you are in this situation but have a more complex tax return, you should probably contact a tax attorney and have them to the negotiation for you. Either way, you may be able to settle for less than you own and put the incident behind you.

If that doesn't work, you may want to look at working out a payment plan with the IRS. This is fairly common practice but it usually requires allowing the agency to draw regular monthly payments directly out of your checking or savings account. If you do use this option, you need to make sure of a couple of things.

First, keep track of the payments you make closely. Donâ€™t simply trust the IRS to be accurate.

Second, make sure that you always have enough money in your account to cover what the IRS takes out. Missing a payment could void your agreement and bring things like penalties, more interest seizure of other assets and wage garnishment.

But let's say none of these options will work. Bankruptcy may be the last resort. While an option, this should be the last option considered. And depending upon your income level, it could be a much more difficult process than working out one of the other plans. Current bankruptcy laws require those filing to prove that they can't pay their debts. If the court determines that this is not the case, you won't simply be allowed to discharge your debts under Chapter 7. Instead, you will be forced into a payment plan that will be court supervised, very strict, and which could drag on for several years.

There is absolutely no doubt that if the law isn't extended, a large number of people will have serious financial problems as a result. There is also no doubt that a lot of people in this position will eventually choose to file for bankruptcy. But there may be other options available to them that are less drastic and which don't negatively impact them in the same way. Anyone facing these issues would be wise to start doing their homework now.

byJim Malmberg
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