Lenders May Give You a Break on Debt, But Uncle Sam Might Not Be So Forgiving

There's a good news/bad news story if you're a borrower in trouble with mortgage debt. The good news is that your lender might be willing to renegotiate your loan to give you a break on your payments or even forgive a portion of the debt. Foreclosure is expensive and it's also bad publicity throwing people out of their houses – lenders simply don't like to do it.

The bad news? The IRS is watching.

Lenders are required by law to report to the Internal Revenue Service (IRS) any amount of debt forgiven to customers. That means that unless you file bankruptcy or are otherwise declared insolvent in court, you'll very likely owe federal tax on the amount forgiven. Also, the IRS is watching if you're a homeowner benefiting from something called a "short sale" – a quick, speedy sale of your home to avoid foreclosure. At the present time, those full proceeds would be a target for a bill from Uncle Sam as well.

There is no question that thousands of Americans are in trouble with mortgage debt, particularly those who might have gotten low- or no-down payment loans that have actually raised monthly payment amounts as interest rates have risen. Some of these loans were structured in a way that as rates have gone higher that the loans were sent into "negative amortization" – where any equity is erased and the borrower finds they actually owe more on the loan than the amount they originally agreed to.

Add a potential tax debt to that situation and you see an entire class of borrowers risking the loss of everything they own.

Congress is trying to deal with the problem. Right now, a bill in the U.S. House of Representative entitled "The Mortgage Cancellation Tax Relief Act of 2007" (HR 1876) would amend the tax code to exempt debt forgiveness on principal home mortgages from being treated as income. The legislation would also help another class of troubled borrowers who negotiate pre-foreclosure "short sales" or deeds in lieu of foreclosure, or whose foreclosure proceeds are insufficient to pay off their mortgage debt.

If you think you're running into this kind of trouble, it's essential to speak with a CERTIFIED FINANCIAL PLANNER™ professional or a tax professional not only to estimate your tax risk, but also to find out if there might be other approaches to your individual situation. It's not wise to count on a guaranteed break from Congress, particularly since the bill is in the early stages.

Some things you might want to discuss with your tax expert or financial planner:

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Is refinancing an option? If you haven't made a late payment and your credit is in relatively good shape, you may still have the option to refinance instead of going for loan forgiveness. Make sure you've checked your credit reports for accuracy before you make this application.

Selling the house quickly. If you have some equity in your home and your credit is still in relatively good shape, it makes the most sense to get out from under your house payments before you risk default or your payments go higher. You'll be able to pull out some of your equity to put in savings to reinvest in another home or condo someday.

Set a budget, rent cheap and rebuild your savings. There's no shame in getting rid of a massive loan and starting over. Granted, renting doesn't have the same tax advantages as owning, but with proper planning, you can pick up the pieces and start again.

June 2007— This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by local member Bill Rodau, MS, MBA, CFP® at *Creative Financial Services*, **262-780-0870**, www.imfeeonly.com . The column is provided for your general information only and you should contact this planner or other professionals for specific advice regarding your unique situation.