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I Received a 1099 from My Home Equity Lender- What Steps do I need to Take?

Tax Consequences of Foreclosure-with a HELOC

By: Beth S. Cohn

It is common for homeowners to have a house that is "upside down", many with first and second mortgages. Houses that were purchased a number of years ago appreciated rapidly in a short period of time and it was easy to pull on the home's equity by securing an equity line of credit. That equity may have been used for many purposes, including home improvements, constructing a swimming pool, funding college educations, purchasing new cars or boats, paying off credit cards and investing in businesses. These loans are second loans behind the original purchase money loan and are commonly called Home Equity Lines of Credit or Home Equity Credit Lines ("HELOCs").

When homeowners are deciding if they can afford to keep their house by continuing to carry their first mortgage and their HELOC, they need to consider whether or not the HELOC will be covered under Arizona's anti-deficiency statutes and what the tax consequences are of a foreclosure or short sale.

In our recent article "*I Received a 1099 from My Lender- Now What*?" we discussed the tax consequences in Arizona of a foreclosure or a short sale when the loan is the **original purchase money loan and there is no HELOC**. This article will examine the tax consequences of a foreclosure when the personal residence has both its original purchase money loan **and** a HELOC. It is important to note, that a refinance of an original purchase money loan with or without a HELOC is not covered in this article.

What is the Difference between a Recourse and a Nonrecourse Loan?

Under Arizona law, if the loan is considered a "purchase money" loan, the house is on 2 ½ acres or less **and** is a single one family or two family dwelling, the lender cannot go after a deficiency (the shortfall between the outstanding debt and the sales price at a foreclosure sale or in a short sale) against the homeowner. A purchase money loan is defined as using the proceeds of the loan to purchase the residence. In Arizona, this is what is frequently referred to as the "anti-deficiency" rules.

With the anti-deficiency rules, the homeowner walks away and does not owe the lender any balance after the foreclosure. The anti-deficiency rules **do not** apply to HELOCs that are used for purposes **other than making improvements to the home**.

The anti-deficiency statutes generally do **not** apply to a HELOC. If the HELOC is not considered a purchase money loan under Arizona law, the homeowner has liability to the lender and the lender can proceed against the homeowner for a deficiency on the HELOC. Even after a foreclosure by the first lender, the lender on the HELOC **can still sue the borrower for the outstanding amount of the HELOC loan.**

How Does a HELOC Impact How Much Tax is Due on a Foreclosure?

As a general principle of tax law, when a lender forgives a recourse debt, the amount forgiven is included in income as cancellation of debt income, unless an exception applies.

Exception 1: Mortgage Forgiveness Debt Relief Act (the "Act") applies. The Act provides that homeowners can exclude from income the discharge of "qualified principal residence indebtedness" on the foreclosure or restructure of such debt on a personal residence of up to $2 million (if married) or $1 million (if married filing separately). A single person is not directly addressed by the law. The Act only applies to debt incurred to acquire, construct or substantially improve any "qualified residence" and certain loans to refinance such debt. HELOCs are not "qualified principal residence indebtedness" **if they are not used to substantially improve the taxpayer's residence.** Therefore, the amount of the income recognized from the forgiveness or discharge of a HELOC is **not** excluded from income.

Exception 2: The homeowner qualifies for another exception to the inclusion of income from the cancellation of the debt, such as insolvency or discharge of debt under bankruptcy cases. Many taxpayers may assume that they are insolvent for the insolvency exception if they believe that their liabilities exceed the fair market value of their assets. This includes IRAs and retirement plans. This determination must be made by a qualified tax or legal professional.

The following illustration details the tax consequences of a foreclosure or a short sale of a personal residence in Arizona where there is both an original purchase money loan and a HELOC. The assumptions are that the property is the owner's primary residence, the Arizona anti-deficiency rules apply to the first loan, but not to the HELOC.

EXAMPLE:

Original purchase price was $200,000, with no money down. House appreciates to $300,000. The owner obtains a HELOC for $50,000 to pay off credit cards. The house is now worth $200,000. The owner falls behind in the payments and the lender forecloses on the first loan for the balance of the loan, which is $190,000.

Bid price at the foreclosure sale is $190,000, and there is a nondeductible loss on the sale of $10,000, as to the first loan.

The lender decides not to proceed against the owner on the HELOC and forgives the balance of $50,000. The homeowner has $50,000 of cancellation of debt income. The Act does not apply. The homeowner would need to qualify for another exception, such as insolvency or discharge of debt under bankruptcy laws. If they do not qualify, then the cancellation of debt income is included as income.

Reporting Requirements

When a HELOC is discharged on the lender's books, the lender is required by the IRS to issue a 1099-C for the forgiven portion of the loan to the borrower. Assuming that no portion of the discharged HELOC is used to make improvements on the residence, the full amount of the discharged debt is generally includable in income unless the borrower qualifies for the insolvency exception or the bankruptcy exception. Form 982 should be filled out to claim any exceptions and filed with the Form 1040 for the applicable year.

Conclusion

These issues are complex and each loan and each situation is different. Do not automatically assume that the amount of a loan that is discharged on a personal residence is excluded from taxable income. In many cases, HELOCs that are forgiven or discharged by lenders are reportable as income from cancellation of the debt unless an exception to reporting applies. There may be different tax consequences depending on the value of the residence and additional questions may arise if the existing loan is a refinance of an original purchase money loan. It is highly recommended that you obtain an analysis by a qualified CPA or attorney.

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