Foreclosure never a cheap affair

By Ilyce Glink and Samuel J. Tamkin, Tribune Content Agency

Q: Love and appreciate your columns. My wife and I tried to sell our home for six years! We owed $520,000 on our mortgages. We started at $650,000 and dropped our price when the bubble hit, to around $520,000. We finally got a cash offer of about $500,000 two years ago, but the bank rejected it and wanted around $550,000.

That buyer walked and after that, we had several contract offers going from $490,000 down to $415,000. The bank rejected them all. We then suffered significant health and financial setbacks and could not pay our mortgage.

Fannie Mae foreclosed on us in December 2014 for our main mortgage amount of about $390,000, and then our lender declared our loan as a bad debt for about $130,000.

We lost all our investment in the purchase of the house and all of the cash we spent improving the house over 15 years, for a grand total of more than $300,000. Now, Fannie Mae now has the house for sale for $539,000.

We wonder if the capital gain on the foreclosure is exempt from tax, and if it is subject to taxation, if Fannie Mae sells it for more than what we owed, does the sale price temper our taxes? Again, thanks for such fine advice.

A: Thanks for your question and your kind comments about our column. We don't think you have too much to worry about. Based on what you have told us, the bank foreclosed on your home and you put way more money into the home that the mortgage amounts. Taking a step back, your "cost" (or basis) in your home for federal income tax purposes is what you paid for the home plus costs of purchase plus capital improvements you put into the home.

It seems to us (based on the information in your email), that you have lost money -- quite a lot of money -- and in no way "made" money that could be subject to federal capital gains taxes. If your lenders wiped your loans off their books, the value of that loss would be about $520,000. The price the lender gets for your home won't make any difference to you for federal capital gains tax purposes.

The only time it really matters what a lender gets for a home is when your debt to the lender is a certain amount and the lender is able to sell the home for an amount that exceeds what you owed the lender.

For example, if you have loans on a property totaling $200,000, the property is foreclosed and the lender sells the home for $400,000, the lender may owe you money.

We doubt the lender will owe you money in this case after you take into account costs of sale, unpaid interest, costs of foreclosure and attorneys' fees. Foreclosure is never a cheap affair.

Here's one thing that might be an issue: if your foreclosure occurred after 2014 or the home wasn't your primary residence, any losses would be considered by the IRS to be income caused by the cancellation of indebtedness, otherwise known as 'phantom income.' When your lender forgives a debt, the IRS considers it income. You don't have the cash in your pocket, but you still owe the IRS tax. In other words, if you owe $600,000 in debt and the lenders only get $500,000, you receive a taxable "gift" of $100,000 from the lender.

Having said that, since this home was your primary residence and your foreclosure was December 2014, Congress passed a law that allows you to exclude this type of income if the home was your primary residence. Your lender should have sent you a tax form 1099C telling you of the amount of cancelled debt. Since the home wasn't sold by the lender until this year, the lender may not have known how much of your debt was cancelled. Now that you heard it was sold, you should get a 1099C form from your lenders.

One last item: if you had purchased your home for $100,000 and over the years, the home appreciated in value and you took out new mortgages over time for larger and larger amounts, you could find yourself having to pay capital gains taxes on the foreclosure even if you don't get cash for the sale. Over the years, you would have gotten money from the refinancings and the IRS will want you to pay tax on the gain between what you paid for the property and what the property was worth at the time the property was foreclosed.

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