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Rocky Mountain Financial Professionals

If You Are Facing Foreclosure, Here Are Tax Issues You Will Confront

Article Highlights:

- Mortgage Forbearance
- Fannie Mae and Freddie Mac
- Penalty Free Pension Plan Withdrawals
- Cancellation of Debt Income

As part of the CARES Act, Congress provided temporary relief for homeowners with federally backed mortgages who were financially impacted by COVID-19. For those unable to keep up with their home mortgage payments, the relief provides mortgage forbearance and a moratorium against foreclosures through August 31, 2020. As related to mortgages, the term "forbearance" means an agreement between a lender and borrower to delay foreclosure while giving the borrower time to catch up on overdue mortgage payments.

As this pandemic continues to wreak havoc on people's finances, the Federal Housing Finance Agency said that Fannie Mae and Freddie Mac will extend foreclosure moratoriums to December 31, 2020 and perhaps longer.

If, because of the pandemic, you cannot make your payments and have not already done so, you should contact your lender to request forbearance for your loan payments. Your lender may allow temporarily lower mortgage payments or pause payments altogether, helping you deal with the current financial hardship.

Along with your financial hardship, you probably should consider the potential tax and financial ramifications.

Whether the forbearance reduces or pauses your payments, during that time, your home mortgage interest—the largest tax deduction for most—will be reduced. However, that may not make any difference if your income has been substantially reduced.

Although most financial gurus advise not tapping your retirement funds for non-retirement purposes, the CARES Act did eliminate the penalties on up to $100,000 of withdrawals from IRAs and qualified plans, and allows the tax on the withdrawals to be spread over a 3-year period. In addition, the funds can be recontributed within the 3-year period. These funds could be used to make mortgage payments; but of course, you may not want to do that if the home will ultimately go into foreclosure. To be eligible for the special provisions of these distributions, you, your spouse or dependent must have been diagnosed with the virus SARS-CoV-2 or with coronavirus disease 2019 (COVID-19) by a test approved by the Centers for Disease Control and Prevention or have experienced adverse financial consequences as a result of the coronavirus, including:

- being quarantined;
- being furloughed, laid off or having work hours reduced;
- being unable to work due to lack of child care;
- closing or reducing hours of a business owned or operated due to the virus or disease;
- incurring a reduction in pay (or self-employment income); or
- having a job offer rescinded or start date for a job delayed.

With the downturn in the economy, many taxpayers find themselves in debt over their heads and end up settling their debts for less than what is owed or have their property repossessed or foreclosed upon. All of those actions will result in the individual being

relieved of debt. In the eyes of the tax code, debt relief is treated as income, and the banks, lenders, etc. are required to issue a Form 1099-C reporting the debt relief income attributable to the taxpayer. That debt relief income is taxable to the taxpayer unless they qualify for relief provided under other provisions of the tax code.

One of those provisions is the insolvency exclusion. A taxpayer is insolvent to the extent the taxpayer's debts exceed their assets at the time of the debt relief.

Another provision is the principal residence acquisition debt relief exclusion, which applies through 2020. However, that exclusion will generally not provide any benefit for homes going into foreclosure due to COVID-19, since those foreclosures will take place in 2021 (unless Congress extends the exclusion, as they've done in the past).

This can all become quite complicated. If you wish to tax strategize, please call this office.