

## Forgiven debt for second homes taxable Legislation grants relief to people who lose primary homes in foreclosure

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Photos by JIM WILSON / New York Times DOUBLED DILE

Lilia Garcia and her husband, Jesus, lost their home in Linden, top photo, to foreclosure and were forced to move into a rental. The struggling couple expects their second home in Stockton, above, which they kept as an investment, will succumb to the same financial fate. Some of the biggest losers in the real estate slump are buyers of second homes who are sitting on a tax time bomb.

Some of the biggest losers in the real estate slump are not purchasers of mansions they could not afford. They are buyers of second homes -- or third ones, for that matter -- who are sitting on a tax time bomb.

Many of these people will lose their properties in foreclosure and then stagger into bankruptcy under the weight of sizable tax bills. While Congress has granted some tax relief to people who lose their primary homes, there is no such aid for those who fall behind on payments on a getaway condo in Las Vegas, a retirement home on the Florida coast or an old house that they are renting out for income.

Bankruptcy lawyers say they are seeing a wave of foreclosures among owners of second homes in such a position - owners who thought they had found sound advice for financial security.

Two years ago, Lilia Garcia and her husband, Jesus, bought their dream house in Linden for \$535,000 and financed it in part by taking out a bigger loan backed by their previous house in nearby Stockton. They decided to hang onto the Stockton house and rent it out, believing that it would more than pay for itself and could be sold years in the future to help pay for college for their two children.

But the Garcias, who earn about \$65,000 a year, fell behind on their payments after their tenant moved out and the interest rate on their mortgage rose, bringing their monthly payments on the rental home to nearly \$2,700 a month, from less than \$1,000. They view foreclosure as inevitable; they have not paid the mortgages on either house for months and now rent a home in Linden.

Then they discovered that they could expect a painful tax on the rental house.

Like many others, the Garcias borrowed more than their homes are now worth. The difference between the amount they borrowed and the rental home's sale price in foreclosure will ultimately be considered taxable income as forgiven debt.

If the rental house sells for \$160,000, which is about what they paid for it in 2003, they may still owe tax on \$120,000 -- the difference between the sale price and the \$280,000 they borrowed against it over the years. That could mean a tax bill of more than \$30,000.

Even if the condition of the economy generally improves, borrowers will face the double problem of foreclosure and then taxes, unless home prices begin to climb rapidly. And no one sees that as likely.

Congress, deciding the tax impact was just too much for the nation's already distressed homeowners, passed limited relief at the end of last year. Under the Mortgage Forgiveness Debt Relief Act, which is effective from Jan. 1, 2007, through Dec. 31, 2009, a homeowner does not have to pay tax on debt forgiven by a lender -- if the loan is backed by the property the homeowner lives in.

Buyers of second homes seem to have thought that if they did not borrow against these homes, they were wasting equity, said Cathleen Moran, a bankruptcy lawyer in Mountain View. "It comes from looking at your house as a piggy bank," Moran said. People borrowed against homes without realizing that the debts would become "a bombshell that's going to go off under you at some point," she said.

For owners with a potential tax bill, there is one way to minimize the damage. Alan Fisher, a bankruptcy lawyer in Boca Raton, Fla., said that negotiating with a lender could prove beneficial. In one of his cases, he said, a lender agreed that foreclosure "fully satisfies all obligations under the loan."

With that statement, he hoped, there would be no outstanding unpaid debt reported by the bank that the Internal Revenue Service could treat as income.

But Fisher said he was not sure how the tactic would hold up in court. "I sure don't want to be the one litigating it."

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