Welcome Relief for Homeowners, Then the Tax Bill

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By: Shaila Dewan

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Come tax time, JPMorgan Chase will be able to write off the $1.5 billion in debt relief it must give homeowners to satisfy the terms of a recent settlement.

But the homeowners who receive the help will have to treat it as taxable income, resulting in whopping tax bills for many families who have just lost their homes or only narrowly managed to keep them.

They are not alone. A tax exemption for mortgage debt forgiveness, put in place when the economy began to falter in 2007, was allowed to expire on Dec. 31, leaving hundreds of thousands of struggling homeowners in financial limbo even as the Obama administration has tried to encourage such debt write-downs.

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Congress routinely allows tax breaks to expire and then reinstates them, usually retroactively, as it did last year. But the stakes are high for families dealing with large declines in their home values, and reinstatement of the tax breaks is more uncertain because of a movement in Congress to broadly overhaul the tax code, which, despite its long-shot prospects in an election year, could end up eclipsing smaller tax issues.

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"Frankly, I'm worried because this should have gotten done before the end of the year and we've got families that have to make decisions now," said Senator Debbie Stabenow, Democrat of Michigan, who is the sponsor of a bill that would extend the mortgage tax break.

The tax exemption was intended to help homeowners who are underwater — that is, who owe more on their mortgages than their homes are worth. According to the real estate data service CoreLogic, there are still more than 6.4 million households underwater.

Typically, if someone lends you money and later says you do not have to pay it back, the I.R.S. counts the amount forgiven as income, except in cases of bankruptcy or insolvency.

Short sales, in which a bank agrees to let homeowners sell their homes for less than they owe (a common way of avoiding outright foreclosure), are a form of canceled debt, as are loan modifications that reduce the amount owed.

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Loss of the exemption is a financial body blow to homeowners already struggling to make ends meet. "I'm in a hole here — I'm trying to work my way out,'" said Eric Heil, 50, a hospital imaging technician who said a divorce and reduced income were forcing him to sell the house he has owned for 18 years in Parma, Ohio. "And the government's going to say you have to pay taxes on it?"

Mr. Heil owes $250,000 on his mortgage, and has found a buyer willing to take the house for $150,000. The bank has agreed. But if Congress does not extend the exemption, he will be forced to count the $100,000 difference as income. That would mean a $28,000 tax bill, and Mr. Heil has no idea how he would afford it.

The number of people using the mortgage debt relief exemption has increased every year, reaching almost 100,000 in 2011, the most recent year for which the I.R.S. has figures. That number could be far greater in 2013, when there were more than a quarter-million short sales, according to Daren Blomquist of RealtyTrac, who estimates that those families received an average debt reduction of roughly $37,000. If the exemption had not been in place, that would have translated to an extra $9,250 tax bill for those in the 25 percent bracket.

Many homeowners are so deeply underwater that they require much more help. Under a separate mortgage settlement involving the five largest lenders, more than 90,000 homeowners received debt relief averaging $109,000 each.

Debt reduction was slow to take off as a tool for preventing foreclosure, but as it has proved to be among the most effective types of loan modification, loan servicers have grown more open to using it. Moreover, while the acting director of the Federal Housing Finance Administration forbade the use of principal reduction on mortgages overseen by Fannie Mae and Freddie Mac, even though it would have saved those entities money, the recent appointment of a permanent director, Mel Watt, has raised the possibility that the ban will be lifted.

"We're finally hitting the sweet spot of principal reduction and mortgage resizing, and all of a sudden the tax relief sunsets," said Lou Tisler, executive director of Neighborhood Housing Services of Greater Cleveland, which helped Mr. Heil with his case. Clients now have to be warned that Congress may not reinstate the exemption, Mr. Tisler said.

Officials in many states have been urging Congress to reinstate the exemption. "It is inherently unfair for the big banks to be allowed to write off these payments while struggling homeowners are hit with new tax bills they can't afford," said Attorney General Martha Coakley of Massachusetts.

A bill in the Senate to extend the exemption has 19 co-sponsors, including two Republicans from states hit hard by foreclosures, Johnny Isakson of Georgia and Dean Heller of Nevada. In the House, Joe Heck, Republican of Nevada, is the bill's sponsor. His three co-sponsors are Democrats.

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In an interview, Senator Isakson said that forgiven debt was nothing more than "phantom income" and should not be taxed. He said it would be unfair to end the exemption for those families who have managed to hold on to their homes.

"It's certainly not a giveaway to anybody, it's not going to grow into some kind of entitlement — in fact, it's going to shrink as time goes by," he said. "These are the people who have tried the hardest to hang on to their homes and keep the economy strong."

The bill may suffer from a general fatigue over homeowner issues or a belief that the Treasury cannot afford to forgo the revenue. (The provision is estimated to cost the government $1.3 billion a year in tax revenues; by comparison, the mortgage interest deduction for homeowners is worth $70 billion a year.) There may also be a sense that the exemption is no longer urgent because the economy, and the housing market, are improving.

Elyse Cherry, chief executive of Boston Community Capital, disagrees.

Her agency runs a program that keeps families in their homes by buying them in short sales and selling them back to the occupants at a reduced price. "I keep talking about this in terms of the tale of two recoveries," Ms. Cherry said. "If you're in middle-class or upper-middle-class areas, things are coming back. When you look at urban and lower-income areas, they're not at all."

"If the problem's over," she added, "then put the exemption back into place and it won't get used much. And to the extent the problem is not over, then the people getting whacked with this tax are the people least able to afford it."

—By Shaila Dewan of The New York Times

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