

**Publication:**The State; **Date:**Feb 10, 2008; **Section:**Your Home; **Page Number:**G1

# DOLLARS & SENSE

## Forgiven homeowners get a break

By **MARK SCHWANHAUSSER** San Jose Mercury News

Federal lawmakers scored some political points in December by easing the rules that can leave homeowners who lose their homes in foreclosure owing taxes on phantom income when lenders cancel some of the debt they owe.

"When you're worried about making your payments, higher taxes are the last thing you need to worry about," President Bush said when he signed the bill, which is expected to save homeowners \$650 million.

But don't take the new law as a cure-all. The federal bill has several limitations. And the bill does nothing for the even bigger number of consumers who trigger phantom income when lenders cancel credit-card debts.

"It's another one of those smoke-and-mirror things," said Daniel D. Morris, a partner with Morris plus D'Angelo in San Jose. "It's feel-good legislation."

The rules surrounding canceled debt are too complex to delve into here. But it often occurs in real estate deals when homeowners renegotiate mortgages or lose their homes in "short sales" or foreclosure sales that fail to cover the principal debt.

Nina Olson, head of the National Taxpayer Advocate, the watchdog arm of the Internal Revenue Service, said in her annual report to Congress that issues associated with canceled debt rank among the biggest headaches facing taxpayers. The IRS is a huge part of the problem, she said.

She said the agency not only does a poor job of explaining the rules in forms, instructions and publications but also has declared that the topic is "out-of-scope" if taxpayers seek advice at IRS walkup centers.

Federal lawmakers pushed through the change in late December because they feared more Americans will reach their financial limits as payments on exotic mortgages spike and home values plunge. In 2006, creditors issued nearly 2 million 1099-C forms to report canceled debt to the IRS and state tax agencies.

"It is a tremendous hardship to have to pay the tax," said Kaye Thomas, an Illinois tax attorney who delves into the issue on Fairmark.com. "They just lost their home, and on top of that they were going to have to pay tax."

But tax pros note that the reprieve is limited. For starters, it applies only to taxpayers who lose their homes in 2007, 2008 and 2009 — not before. Debt forgiven on vacation or second homes still counts as income. And homeowners who refinanced to pay off other bills could still owe taxes.

Perhaps more important, the law provides no relief for consumers who work out deals with lenders to chisel away at credit-card debt.

"People always run into that problem," Joseph Salazar, a partner with S&S Tax Service in San Jose. "When you get in trouble on your mortgage, what do you do? You start hitting up the credit cards and cash advances."

### WRITEOFFS

Many homeowners will be able to write off hundreds of dollars of mortgage insurance premiums on their taxes starting with their 2007 returns, a reward for steering clear of exotic "piggyback" loans.

Congress initially approved the tax break only for 2007, then extended it for three years in late December as the housing market sagged.

However, many people who pay for "PMI," or private mortgage insurance, won't benefit. Only insurance contracts issued after Jan. 1, 2007, qualify. And the tax break is available only to homeowners with adjusted gross income of less than \$100,000; after that it phases out gradually until income hits \$110,000.

For details, see IRS Publication 936.