

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

About This Newsletter

This monthly Newsletter is a free service provided by Gregg Harvey, CPA. It is emailed every month to clients and to select members of the Rochester Regional Chamber of Commerce.

This Month's Contents:

This month's contents include: Foreclosure issues are highlighted, as are commonly overlooked medical deductions.

Short Sales, Foreclosures, and Related Issues

With the real estate situation being what it is, some homeowners find that debt exceeds the fair market value of their home. Not only do such homeowners owe more to the bank than their home is worth, this situation can lead to unexpected tax consequences as well.

First, some definitions:

Short sale - this is a bank workout program where the lender approves the sale if a homeowner is behind on payments and owes more than the property's fair market value. The lender allows a discount, where the sale is approved at less than the amount that is owed.

Deed in lieu of foreclosure - this is a deed instrument in which a mortgagor conveys all interest in the property to the mortgagee to satisfy a loan that is in default and thus avoids a foreclosure. This has advantages for borrowers and lenders. For the borrower there is an

immediate release from the obligation, or most of it. The borrower also avoids the notoriety that comes with a foreclosure. For the lender, the advantages are a reduction in the time and cost of a re-possession and additional advantages if the borrower avoids a bankruptcy.

Foreclosure - This is the legal process reserved by the lender to terminate the borrower's interest in the property after a loan has been defaulted. The lender sets a minimum acceptable auction price, and at sale, the lender keeps the proceeds to satisfy its mortgage as well as any legal costs. If there are excess proceeds they may be used against any other liens or be returned to the borrower. Lenders usually do not want to own property and will go to some lengths to avoid a foreclosure. The process costs them time and money and places a non-performing asset on their books.

Discharge of Indebtedness - (DOI) income to the taxpayer as a result of forgiven debt.

Either a short sale or a foreclosure can result in a Discharge of Indebtedness (DOI) income to the borrower if the lender forgives some or all of the unpaid debt. Cancellation generally results in gross income for the debtor unless an exception applies because the taxpayer is bankrupt or insolvent.

Example 1:

- Original buy price and loan = \$450
- Sell price = 400
- Owner renegotiates loan to \$400
- Owner is solvent

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- This results in \$50 of DOI, which goes on line 21 (Other Income) of the 1040
- The \$40 loss is not deductible

If recourse debt is involved the taking of the property is a deemed sale with proceeds equal to the lesser of fair market value (FMV) at time of foreclosure or the amount of the secured debt. If debt exceeds the FMV, then that is the amount of DOI if it is forgiven. Bid price at sale is usually considered the FMV unless there is proof to the contrary.

DOI occurs in a foreclosure only if the lender discharges any of the deficiency. If the lender fails to pursue then DOI results when the status for enforcing the debt expires. a matter of state law.

When lenders foreclose they must issue a Form 1099-A, Acquisition or Abandonment of Secured Property to the borrower. This provides the date, amount of the outstanding loan, and whether the borrower is liable for balance or not. There is also a different but similar form, the 1099-C, Cancellation of Debt. The lender will determine which applies. If both do then only the 1099-C needs to be filed. The correct form depends on state law and the type of lender.

Example 2:

- Buy price = \$300
- Buyer puts \$15 down, and \$285 is financed
- Borrower then borrows another \$100 against the property

- Assume that time goes by and that loan balances are now \$265 and \$100
- Conditions deteriorate, and the property is sold at auction for \$340
- DOI is $\$340 - (\$265 + \$100) = \25 and the borrower will get a 1099-A or a 1099-C.
- Notice that the borrow also has a taxable gain of $\$340 - \$300 = \$40$.

The rules for non-recourse debt differs from the above, but such loans are not very common with real estate so these rules are not covered here.

The borrowers solvency affects the tax consequences of a forced sale. Basically a taxpayer is liable for DOI up to the point of their solvency.

Example 3:

- Taxpayer owes \$500
- Taxpayer owns land worth \$350
- Bank discharges \$200 of the loan when the taxpayer goes out of business
- Before the discharge the taxpayer is insolvent: $\$350 - \$500 = (\$150)$
- The discharge leads to DOI: $\$200 - \$150 = \$50$

General Foreclosure Information

It usually takes you not making payments for 3 consecutive months before a bank will foreclose. If a borrower sends a payment (partial) and the lender returns it, then the borrower needs to call them. With a mortgage,

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whatever you do, don't ignore their calls. Generally, they want you to stay in your home, especially with the market being so bad right now. Return any messages and take their calls, just explain the situation, they will do lots of different things to work with you to help you out

If you need help and you are late on the mortgage there are new FHA laws that will help you refinance your mortgage.

Not all banks are the same however. With some there is no partial payment program. If a borrower is late, they start foreclosure after 30 days.

The length of time that you are served with a foreclosure notice depends on where you live. In Michigan the rules are as follows:

- Process – Both judicial and non-judicial. Usually the non-judicial process is used, and the Sheriff sells the property
- Process Days – 60 days
- Sale publication days – 30 days
- Redemption period – 30-365 days

A foreclosure is a legal action that permits a lender to acquire ownership and title from a delinquent borrower. There are two types of foreclosure systems that follow the two types of secured real estate loans.

There is a judicial foreclosure system in Mortgage States. There is a non-judicial foreclosure system in Trust Deed States. A few states, like Michigan, allow both Judicial and Non-Judicial foreclosures depending on the loan documents.

Non-judicial sales are almost always quicker than judicial sales. Lenders should always make sure their documents provide for this if possible in that state.

Some states are much more lender-friendly than others. It would be interesting to know if interest rates are lower in those states than in those like New York that drag out foreclosures for so long, costing the lender money and lost income.

Length of time pre-foreclosure is the length of time from commencement of the legal action to the legal sale of the property and varies greatly from State to State. This is the time it takes to process the documents through the legal system and the number of days notice one must give of the sale by publication.

A redemption period enables a borrower to pay off the loan and re-claim the property for a period AFTER the foreclosure sale. In some cases an owner of an underlying junior lien or mortgage also has this right. These times also vary greatly from state to state. This delay greatly affects the ability of a lender to take title to, fix up and rent or re-sell a foreclosure property. It will also affect the amount someone will bid at a courthouse sale.

The IRS, by virtue of Federal law, has 120 days to redeem property from a foreclosure sale. In practice they seldom do this as this means writing a check to the foreclosure buyer. Sometimes they will agree to waive this redemption period. If not, you will have to wait 120 days before you can fix up and re-sell the property.

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The states strike differing balances between protecting the homeowner from losing their home quickly, perhaps because of a temporary financial setback on the one hand, and the legitimate rights of the lender to try to recover the money they have lent in good faith expecting to be paid back.

Note as well that if you hold a junior lien, a second mortgage, you may or may not be entitled to notice of foreclosure. You should check with your attorney, before you make the loan.

The above is general information. If you have a specific case in mind, please contact a real estate attorney.

Don't Overlook All Your Medical Expense Deductions

Dependents

It is common knowledge that taxpayers can deduct qualified medical expenses for themselves and their dependent children. But the law does give other opportunities to deduct medical costs that are not so widely known.

One such deduction is for costs that a taxpayer pays on behalf of others such as an elderly family member, even if they are not claimed as dependents.

Generally taxpayers can claim qualifying medical expenses paid on behalf of individuals whom they could claim as a dependent except for the fact that the individuals claim dependents of their own, file a joint return, or receive gross

income in excess of the exemption amount.

For example, the child of an ill parent can claim payments for that parent's health care costs even though the parent files a joint return and has gross income in excess of \$3,400.

The dependency rules for an unrelated party are stricter. Such an individual must share the same principal place of abode as the taxpayer and be a member of the household for the entire year.

Long-Term Care Costs

Treatment of a chronic illness or a disability can be very costly.

Be aware that services that are otherwise not deductible as medical expenses are deductible as qualified long term care costs.

- Long term care insurance premiums
- Maintenance and personal care services including meal preparation, housekeeping, if these services are to assist with activities that the chronically ill person is unable to do themselves.
- Meals and lodging for an in-home caregiver.
- Nursing homes, assisted living facilities, and dementia facilities are qualified costs. All reasonable costs are deductible if the patient is admitted for medical reasons.

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Commonly Overlooked Deductions

- Nonelective cosmetic surgery (basically, those that promote proper function of the body or preventing or treating illness or disease)
- Dental work, if not “purely” cosmetic
- Hearing aids, eyeglasses.
- Non-physician provided medical services if related to a medical condition. This includes very non-traditional options such as acupuncture and Christian Science healing practices.
- Psychotherapy and psychiatric counseling
- Stop smoking programs, including prescription drugs to help with nicotine withdrawal
- Transportation to and from medical treatment
- Weight loss programs for treatment of physician diagnosed disease

For More Information

For more information on anything covered in this Newsletter, please contact me. I provide tax, accounting, consulting, and other business services such as payroll and medical billing.

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