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After Foreclosure, a Big Tax Bill From the I.R.S.

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Two years ago, William Stout lost his home in Allentown, Pa., to foreclosure when he could no longer make the payments on his $106,000 mortgage. Wells Fargo offered the two-bedroom house for sale on the courthouse steps. No bidders came forward. So Wells Fargo bought it for $1, county records show.

Despite the setback, Mr. Stout was relieved that his debt was wiped clean and he could make a new start. He married and moved in with his wife, Denise.

But on July 9, they received a bill from the Internal Revenue Service for $34,603 in back taxes. The letter explained that the debt canceled by Wells Fargo upon foreclosure was subject to income taxes, as well as penalties and late fees. The couple had a month to challenge the charges.

For those who struggle to pay their bills, who watch their housing payments rise out of reach with their adjustable-rate mortgages, who lose a job or who fall victim to illness, losing one's home can feel like hitting bottom. But one more financial indignity may await as the fallout from the great housing boom ripples across the United States.

"Getting that tax bill," Mrs. Stout recalled, "my first thought was that I needed to see my family doctor to help me with my stress, because we had a big mortgage and other debt and then here came the I.R.S. saying we owe this."

Notices of unpaid taxes, unanticipated and little understood, will probably multiply as more people fall behind on their mortgages, said Ellen Harnick, senior policy counsel at the Center for Responsible Lending, a nonpartisan research and policy center in Durham, N.C.

Foreclosure is one way that beleaguered homeowners can fall into this tax trap. The other is when homeowners are forced to sell their homes for less than the value of the mortgage. If the lender forgives that difference, they are liable for income taxes on that amount.

The 1099 shortfall, as it is called, stems from an Internal Revenue Service policy that treats forgiven debt of all types as income even if the taxpayer has nothing tangible to show for it, unless the debt is canceled through bankruptcy.

The Center for Responsible Lending expects that 20 percent of the home loans made in 2005 and 2006 to people with weak credit, commonly called subprime loans, will end in foreclosure. Because so little money was required as a down payment during the boom, the value of many of these houses may be less than what is owed.

Some people in this predicament are fighting the I.R.S. and winning. Sometimes, lower payments can be negotiated with the I.R.S., tax experts say.

In other cases, bankruptcy or a claim of insolvency can eliminate the tax burden. Sometimes, the bills are sent out erroneously, as banks fail to keep track of home values and what price the properties ultimately sell for.

“The tax laws are far too complex for borrowers to understand,” said Kurt Eggert, a professor at Chapman University School of Law, noting that there are distinctions between selling a house for less than the loan amount and losing one in foreclosure. He says it is crucial to get expert tax advice to sort through the bewildering complications.

The whole concept can be counterintuitive. “Your home has declined in value and you lose it,” Mr. Eggert said. “Then the I.R.S. says you owe tens of thousands in taxes because you got a windfall when the debt was forgiven.”

Mr. Stout has suffered doubly from the downturn in the housing market. He earned $65,000 last year as a salesman for a roofing company. But last winter, his job was cut from a salaried position to an hourly one. Then his hours were reduced, as construction demand eased. Through July he had earned only $25,000, said his lawyer, Stephen G. Doherty, of Bennett & Doherty in Doylestown, Pa., putting him on pace for a pay cut over all this year.

Mr. Doherty set out to appeal the Stouts’ tax bill by arguing that Wells Fargo got the home as collateral so the family did not reap a benefit. The Stouts and their lawyer also hoped to show that Wells Fargo was able to sell the house for far more than $1. Finally, they contended that penalties were inappropriate because they did not receive a tax notice in 2005 or 2006.

After a reporter inquired about the Stout matter, Wells Fargo Home Mortgage said last week that it had reviewed the Stouts’ tax documents and was filing a corrected 1099 tax form to show that no debt had been canceled, because the fair market value of the home was actually more than Mr. Stout had owed.

Mr. Doherty, the Stouts’ lawyer, pointed out that the acquiring lender, in this case Wells Fargo, has some leeway in valuing a house. The fair market value can be the high bid at a sheriff’s sale, or an alternative valuation.

In this case, Wells Fargo’s about-face was tied to an appraisal that Mr. Doherty says he believes was completed before the sale. It set the value of the house at $132,844, eliminating the Stouts’ liability. (Lenders do periodic appraisals once a property is in default, Mr. Doherty said.)

The Stouts found in county records that Wells Fargo had sold the house to U.S. Bank for $106,000 — the same amount Mr. Stout had owed — in March 2006. The house was resold that month for $140,000.

An I.R.S. spokesman would not comment on the Stout matter or how the agency applies the tax rules on forgiven debt, but referred to a document on the I.R.S.’s policies.

Diane Thompson, a lawyer in Godfrey, Ill., for the National Consumer Law Center, says the tax can be a real hardship for some people.

She recalled a client who owed $39,000 to her lender and got a tax bill after her house was sold in foreclosure for $10,000. Ms. Thompson appealed to tax authorities, contending that her client, a part-time waitress, was broke because her debts were greater than her assets.

“If you can prove you are insolvent, the I.R.S. does not treat the forgiveness of debt as income,” Ms. Thompson said. Her client did not have to pay.

Lawyers may also be able to show that the original loan process was so flawed that the borrower is not liable for taxes. Indeed, during the real estate bubble, lenders and mortgage brokers sometimes encouraged homeowners to borrow more based on inflated home values.

Such was the case with Agnes Mouser, a 65-year-old widow who works in the records department in a Houston prison. In 2000, she sought to pay off her credit-card debt with a loan from Beneficial Finance, which sent an appraiser to assess the value of her home.

“A real nice young man came out to see me,” Mrs. Mouser recalled. “He could have been my grandson.”

That appraiser compared her 1977 mobile home with two new standard homes with two-car garages. Using those homes as benchmarks, Beneficial agreed to lend $34,730 on her home, valued at $43,500, in 2000. Mrs. Mouser’s loan carried an interest rate of 14.88 percent, and she paid 7 points, or $2,431, at closing to get that rate, along with $270 to Beneficial for the appraisal.

A spokeswoman for HSBC, the parent company of Beneficial, said it did not comment on matters involving specific customers.

In 2003, when Mrs. Mouser could not meet the payments, she contacted Ira D. Joffe, a lawyer in Houston. He found that her property was valued by the county at $19,970, less than half of what Beneficial had estimated.

“I promised to depose the appraiser’s Seeing Eye dog if there was a lawsuit,” Mr. Joffe recalled telling Beneficial.

Beneficial released the lien. But then Mrs. Mouser got a tax bill for $10,000, or the amount owed on the $29,566 that Beneficial had treated as a canceled loan.

“The tax bill scared her to death,” Mr. Joffe recalled. “It took a letter from an accountant and two letters from me to get the I.R.S. to go away.”