Tax planning and the credit crisis

The last six months of 2007 have seen the major implosion sub-prime lending begin to have a national, and even international, impact on the credit and stock markets.

The combination of expanded sub-prime lending programs with mortgage rates that adjust upward after two to three years, reduced or eliminated down-payment requirements, and a housing market that has seen real estate prices actually decline in many markets, has left many borrowers unable to pay higher monthly mortgages payments, or refinance to more traditional mortgages, and unable to sell their home at a price sufficient to cover the mortgage obligation.

The number of mortgage defaults and subsequent foreclosures is soaring, and the problem is getting worse as many existing sub-prime mortgages re-adjust over the next year.

The foreclosures are not only affecting first-time home buyers with marginal credit histories, but also real estate investors who were often fueling the housing boom of recent years by buying up properties and hoping to profit from a quick turnaround. Many of these real estate investors are finding themselves stuck with multiple properties that are now worth less than the purchase price, and are also falling into foreclosure.

Stocks tied to the lending industry have been hammered, as well as real estate investment trusts, mutual funds and hedge funds tied to real estate or mortgage lending, particularly the sub-prime market.

Although it is not yet clear now deep the crisis will go or how long it will last, people will have many questions about the possible tax consequences this year. What are the planning strategies between now and the end of the year that can help individuals deal with the tax consequences of the credit crisis?

BEWARE THE AMT!

The year 2000 saw many taxpayers who had exercised incentive stock options early in the year when stock valuations were high, get trapped with a tax bill based on an alternative minimum tax at exercise date value, even though by the end of the year the stock had declined in value.

Many of those taxpayers could have solved their tax problem had they sold the related stock before the end of the year. Either through lack of sound tax advice or undue optimism about a rebound, many of those taxpayers did not sell before the end of the year, and suffered dire tax consequences.

Do not let this happen this year. Although not as widespread as the problems of 2000, and not particularly focused on companies likely to be major issuers of incentive stock options, make sure any individuals who have exercised incentive stock options this year where the related stock has declined significantly in value are aware of the AMT risk and the merits of selling the stock before year's end.

Although Congress recently enacted some relief for those caught in this situation in 2000 in the form of more liberal utilization of AMT carryovers, it's probably better not to get caught in the trap in the first place.

WASH SALE RULES

And what about that individual who does have abiding faith in the future of the stock, but acknowledges that it may be safer to sell before the end of the year? Make sure that to include a discussion of the wash sale rules, since a repurchase of the sold stock within 30 days on either side of its sale will nullify any claimed loss.

DISCHARGE OF INDEBTEDNESS

If the sale of foreclosed home does not generate enough funds to cover the mortgage debt, many mortgage lenders may just forgive the remaining debt, rather than try to collect the balance from a taxpayer who is struggling financially. Under current law, this would result in a taxpayer who has just lost their home after having been unable to pay the mortgage suddenly facing a higher income tax this year due to the amount of the forgiven debt being subject to income tax.

Currently, the forgiven debt is included in income, unless an exception applies. One exception applies if the taxpayer is in bankruptcy or insolvent. The excluded portion of the forgiven debt would be limited to the amount of insolvency. Another exclusion applies for real property used in a trade or business. The IRS likely would argue that this exclusion would not be applicable even in the situation of the investor who had purchase multiple residential properties prior to the foreclosure.

Members of Congress and President Bush have proposed some relief from the inclusion of debt forgiveness in income. President Bush has proposed relief for a limited period and limited to the taxpayer's principal residence. Although the relief is likely to have bipartisan support, under the current congressional rules such tax relief may require an offsetting revenue raiser or spending cut, which may be more controversial. Relief of this type was provided in the hurricane relief legislation a couple of years ago.

Since most taxpayers will not want to ask their mortgage lender not to forgive the balance of their debt as the preferable strategy, tax practitioners should make sure that their clients are aware of the tax exposure of debt forgiveness, so that their clients can prepare for it should relief legislation not be enacted or not apply in their situation.

CAPITAL GAINS AND LOSSES

A volatile stock market always raises questions about whether and when to sell items from an investment portfolio to generate capital gains or losses. Taxpayers should be encouraged to look over thief portfolio before year's end to determine if it makes sense from an investment and tax point of view to sell assets to generate a capital loss to offset other capital gains in the portfolio this year, and up to $3,000 of ordinary income.

ESTIMATED TAXES

Tax practitioners have already been concerned throughout the year whether their clients should be paying higher estimated taxes in anticipation that the AMT exemption amount may not be raised. Taxpayers may now have to face possible additional estimated tax payments to cover the possibility of having discharge-of-indebtedness income.

On the other hand, the possibility of generating losses on the sale of investments that have declined in value during the year to offset other capital gains or even up to $3,000 of ordinary income might enable the taxpayer to think about reduced estimated tax payments. Remember, however, that forgiveness-of-indebtedness income is ordinary income, so an abundance of net capital losses this year will not help offset that part of the taxpayer's tax liability significantly.

Members of Congress have discussed relief for those caught with underpayment-of-estimated-tax penalties due to tax law changes or even Congress failing to renew tax breaks, but so far nothing has been enacted. Individuals will want to review their estimated tax obligations and the safe harbors available, particularly the safe harbor based on the prior year's taxes, to try to remain out of penalty situation.

SUMMARY

The credit crisis has already made 2007 a disastrous year for many taxpayers. Careful tax planning can reduce the scope of the disaster or at least prevent adding unnecessarily to the pain.

Although tax practitioners may not find many sub-prime mortgage borrowers among their clientele, the crisis has expanded to have an impact on many investors in real estate and the stock market. Anticipating what issues their clients may face from a tax perspective, and what steps can be taken before year's end to address those issues, can provide a real service to those clients most affected.