



TAX INFORMATION MEMORANDUM

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Subj: Tax Treatment of Compensation Payments for Foreclosures in Violation of the SCRA

1. Tax Treatment of Compensation Payments for Foreclosures in Violation of the SCRA

In a settlement with the United States Department of Justice (DOJ) in July 2012, Capital One N.A. and Capital One Bank (USA) N.A. (together Capital One), agreed to pay approximately \$12 million to resolve a lawsuit brought by the Department of Justice alleging several SCRA violations, including wrongful foreclosures. As part of the agreement, Capital One was required to pay approximately \$7 million in damages to service members, including at least \$125,000 for each wrongful foreclosure plus the amount of any lost equity dating back to July 15, 2006.

Through the dedicated efforts of LTC Mitchell, Deputy Chief of the Army Legal Assistance Policy Division, some clarification has been provided by the DOJ and IRS on how the settlement payments should be treated for tax purposes. All service members who received a settlement payment must file IRS Form 1099 to report the amount on their annual tax return. While the tax treatment of settlement payments will depend on particular facts and circumstances, the following guidance is general information regarding different parts of the settlement payment.

- a. Lump Sum Portion of Settlement Payment.** Generally, you must include the lump sum payment in gross income. In limited circumstances, however, you may be able to exclude part or all of the lump sum payment from gross income. For example, you may qualify to exclude part or all of the payment from gross income if you can show that the payment was made to reimburse specific nondeductible expenses (such as living expenses) you incurred because of the SCRA violation.

Thus, it is likely that you must include most or all of the lump sum payment in your income.

- b. Interest Payment on Lump Sum Portion of Settlement Payment.** You must include any interest on the lump sum portion of your settlement payment in your income.

- c. Lost Equity Portion of Settlement Payment.** If you lost your **main home** in foreclosure, you should treat the lost equity payment as an additional amount you received on the foreclosure of the home. You will have a gain on the foreclosure only if the sum of the lost equity payment and the value of the main home at foreclosure is more than what you paid for the home. In many cases, this gain may be excluded from income. More information on the rules for excluding all or part of any gain from the sale (including a foreclosure) of a main home are on pages 10 through 15 of Publication 523, *Selling Your Home*, which is available on the IRS website, www.irs.gov.

Example 1: John paid \$100,000 to buy his main home. The house was valued at \$85,000 at the time of foreclosure. In 2012, John received a lost equity payment of \$10,000. The sum of the home's value at foreclosure and the lost equity payment is \$95,000 (\$85,000 + \$10,000), which is less than the \$100,000 John paid for the home. Therefore, John does not have a gain on the foreclosure of the home and does not include the \$10,000 lost equity payment in income.

Example 2: The facts are the same as in *Example 1* except that John received a lost equity payment of \$20,000. The sum of the home's value at foreclosure and the lost equity payment is \$105,000 (\$85,000 + \$20,000), which is \$5,000 more than the \$100,000 John paid for the home. Thus, John has a gain of \$5,000 on the foreclosure of the home. John generally can exclude the \$5,000 from income if he qualifies under rules that allow exclusion from income of all or part of any gain from the sale of a main home. Otherwise, John must include the \$5,000 in income in 2012.

- d. The rules that apply to a lost equity payment you received for the foreclosure of a property that was not your main home are different.** The rules for reporting gain or loss on the foreclosure of property that was not your main home are in Publication 544, *Sales and Other Dispositions of Assets*, which also is available on the IRS website, www.irs.gov.
- e. Interest Payment on Lost Equity Portion of Settlement Payment.** You must include any interest on the lost equity portion of your settlement payment in your income.

While this guidance applies directly to settlement payments made by Capitol One, it is applicable to other settlement payments made to compensate service members for foreclosures in violation with the SCRA. (such as with BAC Home Loans Servicing LP, a subsidiary of Bank of America Corporation, and Saxon Mortgage Servicing Inc., a subsidiary of Morgan Stanley). See <http://www.justice.gov/opa/pr/2013/April/13-crt-383.html> for more information.

Note: Unrelated to compensation for SCRA violations, payments are also being received by the general public following the Independent Foreclosure Review, which was established to determine whether eligible homeowners suffered financial injury because of errors or other problems during their home foreclosure process between January 1, 2009 and December 31, 2010. In January 2013, an agreement between 13 mortgage servicers and federal banking regulators was reached that includes an estimated \$3.6 billion dollars in cash payments to be distributed to borrowers whose primary residence was involved in an unlawful foreclosure process. Tax guidance for these payments can be found here: <https://independentforeclosurereview.com/TaxInfo.aspx>

2. Further Information.

Please contact Code 16 for additional guidance, questions or comments regarding this TIM. Code 16 contact information is located in the sidebar.