As shocking as it may sound, sometimes it may in fact make sense to say no to a mortgage modification, even when your house in underwater.

As you may have heard, some of the nation's biggest lenders will be offering loan modifications to their customers, and some of those deals will include reducing the amount the borrower owes, a.k.a. "principal reductions." It's part of a multi-state settlement struck with some of the nation's largest lenders, including Ally Financial, Bank of America, Citigroup, JPMorgan Chase, Citigroup and Wells Fargo. (It has not been finalized.)

While some of those principal reductions will be too small to put homeowners above water, the Huffington Post reports that Bank of America will be offering to write down the loans of more than 200,000 underwater homeowners to market value.

Sounds like a good deal? Not so fast. There are times when a loan modification may make things worse.

If you have a second mortgage and your first mortgage is entirely underwater, then your second mortgage is essentially unsecured. In many cases, these second mortgages can be "stripped," or wiped out, in bankruptcy. But if the lender reduces the balance owed on a first mortgage, then the second mortgage may no longer qualify for this relief. If there is even a penny of value in the home that would go to a second mortgage when the property was sold, the loan cannot be valued as unsecured. That means it must be paid during the Chapter 13 case and it also survives the Chapter 13 as a lien on the property until it's paid off. (Source: Bankruptcy Law Network)

To illustrate, suppose you have a first mortgage of $150,000 with Lender A and a second mortgage for $50,000 with Lender B. You owe a total of $200,000, but your home is worth only $125,000. Let's say Lender A writes down your balance to $124,500. Now your first loan is no longer underwater. However, your second loan still puts you underwater to the tune of $45,500.

However, let's say that instead, you file for bankruptcy and wipe out the $50,000 second mortgage. You still are underwater on the first by $25,000, but you're better off than you were if you took the loan modification. Either way, though, you're still at risk of drowning financially.

There is a third alternative that may solve that problem. Melchionne explained to me that there is nothing to stop a loan from being modified during a Chapter 13 bankruptcy, after the second has been stripped. So in that scenario, you file Chapter 13 bankruptcy, wipe out the second loan of $50,000 then work with the lender to try to get a loan modification on the first that will bring you back onto solid ground again.

Another reason you may want to think twice before you accept your bank's loan modification? Taxes. I've been writing a lot lately about the nightmare that is created when lenders report cancelled debt to the IRS. When a lender forgives part or all of a loan balance totaling $600 or more, that "income" must be reported to the IRS on Form 1099-C. You may be able to avoid paying taxes on that income, if you qualify for an exclusion. But if you don't, you could find yourself with a hefty tax bill.

In the case above, where Lender A writes down the balance on the loan by $25,000 or more outside of bankruptcy, that debt could turn into "income" that could in turn, result in a tax bill of several thousand dollars, depending on the taxpayer's tax bracket. Debts discharged in bankruptcy, however, are not taxable.

Sound complicated? It is. But that's why it is important to get good advice, and meeting with a bankruptcy attorney would be the place to start. But timing is crucial, and missteps can be costly. So before you accept your mortgage lender's offer to modify your loan, tell the lender you have to consult your attorney first.

The Law Office of Anand "Lucky" Jesrani is experinced in handling such matters. Call our office to discuss your options during a free, no-obligation, consultation. Our number is: 530-241-3350.

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