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Taxation of Foreclosures and Short Sales

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Introduction

The real estate industry, on a large-scale basis, has been flooded with foreclosures, deeds-in-lieu of foreclosure, and short sales of real property. These distress sales and foreclosures are the result of a convergence of tightening credit, falling property values, and the consequences of prior lending practices.

Adding insult to injury, owners of real property facing these circumstances, and generally already under financial strain, may be unpleasantly surprised to learn that two types of taxable income can result from a foreclosure, deed-in-lieu of foreclosure, or short sale: capital gains and forgiveness of debt income (also known as cancellation of debt—COD income). COD income has also been referred to as "phantom income." Both types of income can trigger unexpected taxes for the owner.

This legal article discusses the income tax consequences to the borrower in the event of foreclosure, in the event the borrower simply transfers title to the lender (deed-in-lieu of foreclosure), and if the borrower sells the property to another in a short sale in which a lender accepts less than the balance due on the loan as payment in full. This article has been updated to reflect the recent California Mortgage Debt Forgiveness Tax law signed by the governor on April 12, 2010 as part of the California Conformity Act of 2010.

Q 1. Are foreclosures, deeds-in-lieu of foreclosure, and short sales subject to federal tax income taxation?

A Yes. However, the income is taxed differently depending on several factors, including whether there was a foreclosure, a deed-in-lieu of foreclosure given to the lender, or a short sale (a sale where the lender agrees to reduce the amount owed in order to facilitate a sale), and whether the underlying debt is "recourse" (the borrower is personally liable for the debt) or "nonrecourse" (the borrower is not personally liable for the debt).

For federal income taxation as a result of foreclosure, see generally 26 U.S.C. §§ 1001 through 1016. For federal income taxation of short sales, see generally 26 U.S.C. §§ 61, 108 and 1001 through 1016.

TAXATION OF FORECLOSURES OR DEEDS-IN-LIEU OF FORECLOSURE

Q2. What is the difference between a foreclosure and a deed-in-lieu of foreclosure?

A A foreclosure refers either to a trustee's sale foreclosure (not a judicial proceeding) or to a judicial foreclosure (a judicial proceeding). A deed-in-lieu of foreclosure means that the lender has agreed to accept title to the property and the borrower transfers title to the lender rather than waiting until the lender forecloses on the property. A deed-in-lieu of foreclosure is not a special instrument. It is simply a conveyance of the property to the lender by grant deed or quitclaim deed; and, in exchange, the lender cancels the promissory note secured by the real property. In this way the lender can avoid the foreclosure process to regain title to the property.

However, a borrower cannot simply transfer title to the lender without the lender's permission. Because some lenders have refused to negotiate and accept the deed-in-lieu of foreclosure, some creative homeowners have quitclaimed the property to the lender anyway, and have recorded the instrument without the lender's permission.

In 1993, the California legislature passed a statute to protect lenders from involuntary (and invalid) transfers of real property to the lender. The lender must record a "notice of nonacceptance of a recorded deed" in the county where the real property is located. Redelivering a grant of the real property back to the original homeowner (e.g., borrower) does not legally retransfer the title. (Cal. Civ. Code § 1058.5.)

A lender may not want to take a deed-in-lieu of foreclosure because taking title in this manner does not extinguish any junior liens. A foreclosure by a senior lienholder essentially wipes out all junior liens.

Q 3. How does the owner receive "income" from a foreclosure or a deed-in-lieu of foreclosure?

A A foreclosure proceeding, whether through a trustee's sale or judicial foreclosure, and a deed-in-lieu of foreclosure given to the lender are treated the same as a sale for income tax purposes. The foreclosure or deed-in-lieu of foreclosure is reported on the taxpayer's tax return as a sale or exchange in the year the foreclosure is finalized or the deed-in-lieu of foreclosure is given to the lender.

In a foreclosure or deed-in-lieu of foreclosure, the owner can receive "capital gain or loss" as in any other sale of real property (i.e., be subject to capital gains taxation or receive a credit for a capital loss). Additionally, the owner can receive "forgiveness of debt" income. This is also referred to as "cancellation of debt" (COD) income. Whether the owner is subject to taxation on COD income may depend on whether the debt is "recourse" or "nonrecourse." If the debt is a recourse debt, the owner may be deemed to have received taxable income in the amount of debt that is forgiven by the lender (except in certain situations discussed below where the owner will not be taxed). If the debt is nonrecourse debt, there is no taxable income from forgiveness (or cancellation) of debt, but the owner may be still be subject to capital gains taxation.

Q4. What is "nonrecourse" debt?

A Under California law, a debt is considered "nonrecourse" when a loan is made under either one of the following two circumstances:

- (1) When the loan is made to purchase a one-to-four unit property and the borrower intends to occupy at least one of the units, or

(2) When the seller carries back financing for all or a portion of the purchase price of any real property.

(Cal. Code Civ. Proc. § 580b.)

In the event of default by the borrower, the lender, or financing seller, is restricted to recovering the property with no right to proceed against the borrower for any deficiency should the property be worth less than the loan amount.

Q5. What is "recourse" debt?

A Under California law, a "recourse" debt is one in which neither of the two exemptions in Question 4 occurs.

Examples of recourse debt are refinances of existing mortgages, home improvement loans, equity lines of credit, and loans other than seller financing, securing a debt for purchase of property that is not an owner-occupied one-to-four unit property. The lender is not limited to taking the property back and the borrower may be personally liable on the debt. If the lender chooses to foreclose using a trustee's sale, then the lender waives the right to go after the borrower for the deficiency despite the fact that the loan was a recourse debt. In order to go after a deficiency judgment, the lender must go through a judicial foreclosure process.

Q6. How is the amount realized (taxable income) calculated for a "recourse" debt in a foreclosure?

A If the debt is recourse debt, meaning the owner may be personally liable for the debt, the amount realized is calculated in a two-step approach.

First, you take the difference between the Fair Market Value (FMV) of the property (usually the sales proceeds at the judicial foreclosure or trustee's sale) and the Adjusted Basis in the property. Generally, the Adjusted Basis consists of the purchase price of the property plus any capital improvements (less depreciation, if the property is investment property). This difference is the capital gain or loss. If the FMV exceeds the amount of the Adjusted Basis, then the borrower has realized a capital gain at the time of the transfer (foreclosure). If the Adjusted Basis exceeds the FMV, then the borrower has a capital loss.

Second, you take the difference between the amount of the cancelled debt (e.g., unpaid loan amount) and the sales proceeds at the foreclosure (FMV). This is the forgiveness of debt (cancellation of debt) income and it is treated by the IRS as ordinary income despite the fact that the borrower has received no cash at the time of the foreclosure.

However, if the cancelled debt amount is considered "qualified principal residence indebtedness" pursuant to the Mortgage Forgiveness Debt Relief Act of 2007(federal law) and SB 401 (the Conformity Act of 2010—California law), there will be no taxation on this forgiveness of debt (COD income). See Question 9 for a definition of "qualified principal residence indebtedness."

RECOURSE DEBT

Example One:

1. The unpaid balance of the loan is \$300,000.
2. The FMV of the property is \$250,000.

3. The taxpayer's adjusted basis in the property is \$200,000.

Assume the lender forecloses and will forgive the underlying debt.

Step one:

FMV (\$250,000) less taxpayer's adjusted basis (\$200,000) results in capital gains for the taxpayer.

FMV	\$250,000
Less Adjusted Basis	\$200,000
Capital Gains	\$ 50,000

Step two:

Amount of cancelled debt (amount owed on \$300,000 loan) less FMV (\$250,000) is ordinary income to the taxpayer.

Amount Owed	\$300,000
Less FMV	\$250,000
Ordinary Income	\$50,000

Note: If a lender chooses to foreclose through a trustee's sale and is barred from obtaining a deficiency judgment by the one action rule under California Code of Civil Procedure Section 580d, it is likely the IRS will still consider that the underlying debt as a recourse debt and it will be subject to debt forgiveness income. (See Rev. Rul. 90-16.) However, there may be no taxation of this income under The Mortgage Forgiveness Debt Relief Act of 2007.

RECOURSE DEBT

Example Two:

If the FMV at the foreclosure sale is more than what the lender is owed, there will be no forgiveness of debt and, thus, no ordinary income to the taxpayer.

1. The unpaid balance of the recourse debt is \$300,000;
2. The FMV of the property is \$400,000;
3. The taxpayer's adjusted basis in the property is \$200,000.

Step one:

FMV (\$400,000) less taxpayer's adjusted basis (\$200,000) results in capital gains for the taxpayer.

FMV	\$400,000
Less Adjusted Basis	\$200,000
Capital Gains	\$200,000

Step two:

The debt is fully paid (since the FMV of \$400,000 exceeds the unpaid loan amount of \$300,000) resulting in no forgiveness of debt.

Q7. How is the amount realized (taxable income) calculated for a "nonrecourse" debt in a foreclosure?

A If the debt is nonrecourse, meaning the owner is not personally liable for any deficiency (beyond the value of the property), the amount realized is the difference between

- (a) the greater of: (i) the FMV or (ii) the entire outstanding debt; and
- (b) the adjusted basis of the property.

This amount is treated as capital gains and there is no taxation for forgiveness of debt income.

Even though the adjusted basis might exceed the FMV and the outstanding debt, generally no capital loss would be allowed because nearly all nonrecourse debt is associated with a principal residence. (Capital losses are applicable only to investment property.)

NONRECOURSE DEBT

Example:

1. The unpaid balance of the loan is \$300,000;
2. The FMV of the property is \$250,000;
3. The taxpayer's adjusted basis in the property is \$200,000.

Greater of FMV (\$250,000) or entire unpaid debt (\$300,000) minus taxpayer's adjusted basis (\$200,000) results in capital gains to the taxpayer.

Greater of
FMV (\$250,000)
OR
Unpaid Debt (\$300,000)

Greater of the above	\$300,000
Less Adjusted Basis	\$200,000
Capital Gains	\$100,000

Q8. How is a deed-in-lieu of foreclosure treated for tax purposes?

A A deed-in-lieu of foreclosure is treated as a sale and taxed just like a foreclosure. See Questions 6 and 7 above.

TAXATION OF SHORT SALES

Q9. What are the tax implications of a short sale?

A

Cancellation of Debt (COD) Income

A short sale, where the lender agrees to reduce some or all of the outstanding debt, may give rise to forgiveness of debt income (also called "cancellation of debt" or COD income). The amount of the debt that the lender agrees to write off is treated as "ordinary income" (as opposed to capital gains income which is taxed at a lower rate). Even though the lender may be taking this action to facilitate the sale by the owner who is under a notice of default and facing a foreclosure, the agreement between the owner and the lender is considered voluntary and the amount of the loan written off by the lender is treated as forgiveness of debt (cancellation of debt--COD). The taxpayer will generally receive a 1099 tax form from the lender in the amount of the cancellation of debt.

This forgiveness or cancellation of debt which is treated as "ordinary income" under certain circumstances may or may not be subject to taxation.

Federal Mortgage Forgiveness Debt Relief

Under the Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) signed by the President on December 20, 2007, Internal Revenue Code §108(a)(1)(E) was added and provides that a taxpayer will not be taxed upon cancellation of debt income if the following conditions are met:

- The property sold in the short sale is the taxpayer's principal residence, as that term is used in IRC §121.
- The cancellation of debt is **Qualified Principal Residence Indebtedness**** under IRC Section 163(h)(3)(B).
- The indebtedness is discharged after January 1, 2007 and before January 1, 2013. (The end date was increased by three years from 2010 to 2013 pursuant to H.R. 1424, the Emergency Economic Stabilization Act of 2008).

****Qualified Principal Residence Indebtedness** is a loan secured by the residence used to acquire, construct or substantially improve the residence. The income relief provided is capped at \$1,000,000 in the case of a married person filing a separate return and \$2,000,000 for all others.

Any reduction of indebtedness excluded by IRC §108(a)(1)(E) will be applied to reduce the basis of the taxpayer's principal residence, but not below zero. This could result in a higher amount of capital gains tax owed by the taxpayer.

California Mortgage Debt Forgiveness Relief

California law, SB 401, conforms California Revenue and Tax Code Section 17144.5 to federal law, but with the following changes:

- (1) The maximum amount of qualified (1) principal residence indebtedness is \$800,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$400,000 for married couples or registered domestic partners filing separately; and
- (2) The maximum amount of debt relief income that can be forgiven is \$500,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$250,000 for married couples or registered domestic partners filing separately; and

(3) California's debt relief statute applies to property sold on or after Jan. 1, 2009 and before Jan. 1, 2013.

Qualifying taxpayers who have already filed their 2009 California tax returns should file **Form 540X, Amended Individual Income Tax Return**, to subtract the amount of debt relief from income. To expedite processing, write "**Mortgage Debt Relief**" in red across the top of the amended tax return. Taxpayers must attach a copy of their federal return, including **Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)**, with their state tax return.

Capital Gains Income

Finally, if the owner has owned the property for some time and has refinanced to take out some of the equity, the owner could be subject to capital gains taxation when selling the property as well. For example, the borrower has a remaining loan on the property when the borrower refinances in order to buy an investment property (or to buy a car, to take a vacation, consolidate credit card debt, etc.) and now owes \$300,000 to the lender. Thus, the taxpayer's adjusted basis may be lower than the outstanding balance on the loan (see the example below).

The tax calculation for any capital gains income looks just like step one when calculating capital gains income for a foreclosure sale of recourse debt.

Example:

1. The unpaid balance of the loan is \$300,000;
2. The sales price (FMV) is \$250,000;
3. The taxpayer's adjusted basis in the property is \$50,000.

Sales price (FMV \$250,000) less taxpayer's adjusted basis (\$50,000) results in capital gains for the taxpayer.

Sales Price (FMV)	\$250,000
Less Adjusted Basis	\$50,000
Capital Gains	\$200,000

Additionally, the taxpayer will have ordinary income from the lender's write off of any debt, which in this example would be \$50,000 (** See the discussion above in this question to determine whether or not this would be taxable)

Loan Balance	\$300,000
Less Sales Price	\$250,000
Ordinary Income	\$50,000

TAX EXEMPTIONS

Q 10. *Are there any other exemptions from the taxation of cancellation of debt income?*

A Yes. There are four other circumstances, in addition to what was discussed in Question 9, where the taxpayer can get relief from taxation on cancellation of debt income:

- (1) The taxpayer is insolvent (the taxpayer's debts exceed their assets, but the cancellation of debt is forgiven only to the extent of the insolvency);
- (2) The debt is discharged as part of a bankruptcy proceeding;
- (3) The debt discharged is qualified farm indebtedness; or
- (4) The debt discharged is qualified business indebtedness.

For all of the above, any reduction in indebtedness will be applied to reduce the taxpayer's basis in the property.

(26 U.S.C. §§ 108(a), 108(b), 108(c) and IRS publication 908.)

Note, however, it is likely that many taxpayers currently subject to cancellation of debt income will qualify for the insolvency exemption from taxation. Taxpayers should be advised to speak with their own tax advisors as to whether they meet the insolvency exemption.

Q11. Are there any exemptions from the capital gains taxation in a foreclosure, deed-in-lieu of foreclosure or short sale if the property is a principal residence?

A Yes. If the sale, whether through a foreclosure or deed-in-lieu or short sale, generates capital gains and if the property was the seller's principal residence, the seller may be able to use the capital gains exclusion of \$250,000 if single and \$500,000 if married filing a joint return. This exclusion does not apply to ordinary income from cancellation of debt.

MISCELLANEOUS

Q12. Which is better for an owner facing a distress sale: a foreclosure, a deed-in-lieu of foreclosure or a short sale?

A Any of these situations will impact the owner's credit negatively. Additionally, the owner may have a significantly different tax liability depending on the disposition of the property. Consequently, this is a question that the owner needs to discuss with their own tax advisor.

Q13. What is a quick summary of these taxation rules?

	Recourse Foreclosure/ Deed-in-Lieu	Nonrecourse Foreclosure/ Deed-in-Lieu	Short Sale
Capital Gains	FMV Less Adjusted Basis	Greater of FMV or Outstanding Debt Less Adjusted Basis	FMV Less Adjusted Basis
Ordinary Income	Outstanding Debt Less FMV *	No Ordinary Income	Amount of Debt Forgiven*

*No Ordinary Income if property is considered a "Qualified Principal Residence Indebtedness" (See the discussion in Question 9).

Q14. Does California follow the federal COD debt relief rules set forth above?

A Not exactly. California law, SB 401, conforms California Revenue and Tax Code Section 17144.5 to federal law, but with the following changes:

- (1) The maximum amount of qualified principal residence indebtedness is \$800,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$400,000 for married couples or registered domestic partners filing separately; and
- (2) The maximum amount of debt relief income that can be forgiven is \$500,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$250,000 for married couples or registered domestic partners filing separately; and
- (3) California's debt relief statute applies to property sold on or after Jan. 1, 2009 and before Jan. 1, 2013.

Q15. *Where can readers obtain more information on the subjects covered above?*

A Information is available from a variety of sources, including:

- * The Internal Revenue Service (IRS) (<http://www.irs.gov/>), which has detailed publications available for free on many tax related subjects. For more information, see [IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments](#), and IRS Web page, [The Mortgage Forgiveness Debt Relief Act and Debt Cancellation](#).
- * The IRS Tele-Tax system, which is an automated voice message information system with recorded information on many commonly asked tax questions. Tele-Tax can be reached by calling (800) 829-4477.
- * A tax professional, such as a certified public accountant, tax attorney, or enrolled agent.

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