

## Taxation of Foreclosures and Short Sales

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### Introduction

It has been some time since the real estate industry, on a large-scale basis, has had to deal with foreclosures, deeds in lieu of foreclosure, short sales and other distress sales of real property. Unfortunately, distress sales of real property, resulting from a convergence of tightening credit, falling property values, and the consequences of prior lending practices, are all too common currently and do not appear likely to end any time soon.

Seemingly adding insult to injury, owners of real property facing a distress sale, 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 (cancellation of debt) 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, 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.

### 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

### Q 4. 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.

### Q 5. 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.

### Q 9. What are the tax implications of a short sale?

A 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" 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). 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. 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.

Recently passed California law, SB 1055, conforms California Revenue and Tax Code Section 17144.5 to federal law with the following exceptions:

- (1) The maximum amount of acquisition indebtedness is reduced to \$800,000 for couples filing jointly and \$400,000 for individual filers;
- (2) The maximum amount of debt relief income that can be forgiven is \$250,000 for couples filing jointly and \$125,000 for individual filers; and
- (3) California's debt relief statute applies to property sold on or after January 1, 2007 and before January 1, 2009.

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 would look like step one in calculating a foreclosure sale of recourse debt.

## SHORT SALE

### 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
<u>Less Adjusted Basis</u>	<u>\$50,000</u>
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
<u>Less Sales Price</u>	<u>\$250,000</u>
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.

**Q** 11. *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

**Q** 12. *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.

**Q** 13. *What is a quick summary of these taxation rules?*

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

\*No Ordinary Income if "Qualified Principal Residence Indebtedness" (\*\*See the discussion in Question 9)

**Q** 14. *Does California follow the debt relief rules set forth above?*

**A** Recently passed California law, SB 1055, conforms California Revenue and Tax Code Section 17144.5 to federal law with the following exceptions:

1. The maximum amount of acquisition indebtedness is reduced to \$800,000 for couples filing jointly and \$400,000 for individual filers;
2. The maximum amount of debt relief income that can be forgiven is \$250,000 for couples filing jointly and \$125,000 for individual filers; and
3. California's debt relief statute applies to property sold on or after January 1, 2007 and before January 1, 2009.

**Q** 15. *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.
- 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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