

## How Short Payoffs and Foreclosures are Taxed

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During the early 1990s, foreclosures and sales involving property worth less than the debt it secured seemed to be facts of economic life. Foreclosures, short sales, and other distress transactions had become a regular part of the real estate market.

Still, it comes as a surprise to many people that a property owner can actually lose a property through foreclosure and be liable for payment of income tax on the foreclosure. The same is true when property is sold in a "short sale" in which the lender accepts less than the full amount due.

Surprise or not, it is true that two types of income can result from a foreclosure or short sale: capital gain or loss, and relief of indebtedness income. This legal memorandum discusses the income tax consequences of foreclosures and of sales in which a lender accepts less than the balance due on the loan as payment in full.

### **Q 1. What are the federal income tax results of a foreclosure?**

**A** A completed foreclosure is treated the same as a sale for income tax purposes. It is reported on the taxpayer's tax return as a sale or exchange in the year the foreclosure is finalized.

As with other sales, a foreclosure can result in either gain or loss. Gain or loss is the difference between the net foreclosure proceeds ("amount realized") and the borrower's adjusted basis in the foreclosed property. "Basis" is usually the amount the taxpayer paid for the property when it was purchased. "Adjusted basis" means basis, plus the cost of improvements added to the property, minus depreciation. If the seller did not acquire the property by purchase, basis is calculated differently. ( 26 U.S.C. §§ 1001 through 1016.)

### **Q 2. What are the federal tax results of a short sale?**

**A** A short sale can result in both capital gain or loss, and relief of debt income. These are calculated separately. (See 26 U.S.C. § 61 and §§ 1001 through 1016.)

### **Q 3. What are capital and ordinary assets?**

**A** If property is held for a purpose other than resale or inventory, it is generally considered a "capital asset." There is no such thing as "debt relief" loss. Gain or loss on the sale of capital asset is called (and taxed as) capital gain or capital loss.

An example of a capital asset is a personal residence. Another example is an office building used in a trade or business.

If property is held for resale, the assets are considered inventory, or ordinary (non-capital) assets. Gain or loss on the sale of inventory is called (and taxed as) ordinary gain or loss.

An example of property held for resale is lots or subdivision units held by the developer.

(See 26 U.S.C. §§ 1221 and 1231.)

### **Q 4. How is capital gain or loss calculated in a foreclosure or short sale?**

**A** Capital gain or loss is the difference between the taxpayer's basis in a capital asset (usually cost, plus improvements, minus depreciation) and the price the property sells for at the foreclosure sale or short sale.

If the basis is greater than the foreclosure or short sale price, the difference is capital loss. If the basis is less than the foreclosure sales price, the difference is capital gain and is generally taxable.

Capital loss on business or investment property can offset other types of income and lower the taxpayer's taxes for the year in which the foreclosure occurs. However, capital loss on personal use property, such as the taxpayer's residence, cannot offset other types of income and gives the taxpayer no tax benefit.

**Q 5. How about some examples of how capital gain works?**

**A** Here are several examples:

Example 1: Loan was obtained to purchase commercial property (recourse debt). Loan balance is \$300,000. Foreclosure proceeds are \$350,000. The borrower's adjusted basis (purchase price, minus depreciation) is \$250,000.

Amount Realized (foreclosure proceeds)	350,000
Borrower's Basis	-250,000
Capital Gain	100,000

Example 2: Loan was obtained by refinancing the borrower's residence which she previously owned "free and clear" (recourse debt). Loan balance is \$300,000. Foreclosure proceeds are \$250,000. The borrower's adjusted basis (purchase price, plus bathroom added) is \$250,000.

Amount Realized (foreclosure proceeds)	250,000
Borrower's Basis	-250,000
Capital Gain	0

If the lender is barred from pursuing the borrower for the difference (e.g., the lender used a trustee sale foreclosure, which is the most common foreclosure method in California), or if the lender forgives the difference, the borrower will also be liable for debt relief income, which is taxed as ordinary income unless an exemption applies. (See Question 12)

Example 3: Loan was obtained to purchase the borrower's residence, and is secured by that residence (non-recourse debt). Loan balance is \$225,000. Foreclosure proceeds are \$350,000. The borrower's adjusted basis (purchase price, plus room second floor added) is \$250,000.

Amount Realized (foreclosure proceeds)	350,000
Borrower's Basis	-250,000
Capital Gain	100,000

Example 4: Loan was seller financing on the purchase of vacant commercial-zoned land (non-recourse debt). Loan balance is \$325,000. Foreclosure proceeds are \$300,000. The borrower's adjusted basis (purchase price, plus retaining wall added) is \$275,000.

Amount Realized (Loan Balance)	325,000
Borrower's Basis	-275,000
Capital Gain	50,000

In this example the amount realized is the loan balance, not the foreclosure proceeds. This is because the amount realized is either the loan balance or the foreclosure proceeds, whichever is greater.

**Q 6. What other kind of income or loss can result from a foreclosure, in addition to capital gain or loss?**

**A** In addition to capital gain or loss, the borrower can also be taxed on "debt relief" income.

**Q 7. What if the borrower pays a debt off at a discount?**

**A** If the lender accepts less than the full balance due (i.e., the lender gives a discount on the payoff) to mark the loan paid in full, the difference between the loan balance and the amount paid is debt relief income. Debt relief income is taxable as ordinary income. (26 U.S.C. § 61 (12).)

**Q 8. What about debt relief on recourse debt?**

**A** If the borrower is personally liable for the debt (also called “recourse debt”), the “debt relief” rules will apply. This means the borrower may have to report and pay ordinary income taxes on the amount of debt relief income. This debt relief income tax is in addition to any capital gain income tax the seller may owe.

Debt relief is also called “discharge of indebtedness” or “relief from indebtedness.”

The amount of debt relief is equal to the amount of debt that is discharged or forgiven, minus the amount “realized” (i.e., net proceeds) from the foreclosure sale. It will not matter whether the purchaser at the foreclosure sale is the lender or third party bidder.

Capital gain or loss, and debt relief income, are each calculated and reported separately.

An example of recourse debt is a bank loan obtained to finance the purchase of an office building. Another example is a loan obtained to add improvements to a residence the borrower owns.

**Q 9. What about debt relief on “nonrecourse debt”?**

**A** If the borrower is not personally liable for the debt (also called “nonrecourse debt”), there is no debt relief income to be taxed. For a nonrecourse debt, the principal balance of the loan at the time of the foreclosure is considered the amount realized on the sale, even if the value of the property is less than the principal balance of the loan.

An example of nonrecourse debt is a loan obtained to purchase a personal residence of the borrower. Another example is seller financing carried on any type of real property. (These examples assume that the property is in California and that the loan is not modified after it is made. A number of other special rules can affect whether a loan is nonrecourse.)

**Q 10. Can you explain debt relief income further?**

**A** Debt relief income is also called cancellation of debt (COD) income. Debt relief in distressed real estate situations can result from:

- Debt restructuring that results in reduction of the amount of a recourse or non-recourse debt.
- Transfer of property to a lender, that is accepted by the lender in full satisfaction of the debt even though the property is worth less than the balance of the debt. This includes transfers by deed in lieu of foreclosure; sale under power of sale in a deed of trust (because California law bars a deficiency after a non-judicial foreclosure); judicial foreclosure (if the creditor waives the right to seek a deficiency judgment); and other conveyances.

**Q 11. How is a deed in lieu of foreclosure treated?**

**A** For non-recourse debt, the amount “realized” is the balance of the loan. This means the borrower will have capital gain or loss, but will not have debt relief income.

For recourse debt, the borrower can have both capital gain or loss, and debt relief income. The result depends on whether the value of the property is more or less than the loan balance.

For recourse debt, the loan balance or the property value, whichever is less, will be used in calculating capital gain or loss, and the borrower will be liable for debt relief income tax on the loan balance minus the property value.

**Q 12. Do the debt relief income rules always apply?**

**A** No. Exemptions from the debt relief income rules are provided (i.e., debt relief income tax can be avoided) for:

- Borrowers who discharge debt through bankruptcy.
- Borrowers who are insolvent (even though not in bankruptcy), to the extent of the insolvency. Insolvency means that the taxpayer’s debts exceed his or her assets. If the debt cancellation results in the taxpayer’s remaining debts being less than his or her assets, the borrower must report and pay tax on debt relief income to the extent he or she has been made solvent as a result of the debt cancellation.
- Borrowers with a discharge of qualified farm indebtedness.

If a borrower meets one of the above exemptions, the amount excluded from debt relief income must be used to reduce the following tax “attributes” in the following order:

- Net operating loss and net operating loss carry forward.
- General business credit, reduced by one-third of excluded debt relief income.
- Minimum tax credits, reduced by one-third of excluded debt relief income.
- Net capital loss and capital loss carry forward.
- Basis reduction, limited to basis before reduction over remaining undischarged liabilities.
- Passive activity losses and credit carry forwards.
- Foreign tax credit carry forwards.

However, a borrower who is insolvent or in bankruptcy can, instead of following the order above, elect to reduce the basis of any remaining depreciable property by the amount of debt relief. This is limited to the amount of the taxpayer’s depreciable property as of the beginning of the tax year following discharge.

If the borrower is solvent, any debt reduction involving purchase money, seller-carried financing will be treated as a reduction in purchase price that affects the borrower’s basis instead of being treated as gross income.

If the borrower is solvent and the debt is “qualified real property business indebtedness,” the discharged amount will not be treated as gross income but will be treated as a reduction in basis first in the subject property, and then in all other depreciable property owned by the borrower. Any debt relief that exceeds basis will be treated as discharge of indebtedness income.

(See 26 U.S.C. § 108.)

**Q 13.** *What does “qualified real property business indebtedness” mean?*

**A** “Qualified real property business indebtedness” is debt incurred or assumed in connection with real property that is used in a trade or business and is secured by that property. (26 U.S.C. § 108(c).)

**Q 14.** *How about an example of the application of a debt relief rule?*

**A** Here’s an example:

Borrower owns a commercial building securing a “qualified real property business indebtedness” with a balance of \$200,000. Borrower’s adjusted basis (cost, minus depreciation) is \$70,000. Value is \$110,000. Lender accepts a short payoff of \$110,000. As a result, the borrower:

- Has a basis of zero in the property (due to the reduction of basis rule).
- Has debt relief income of \$20,000 (\$90,000 discharged, minus \$70,000 adjusted basis).

**Q 15.** *When a lender issues a 1099 in connection with a foreclosure or short sale, is the amount shown in the 1099 taxable?*

**A** Not necessarily. The law requires lenders to issue 1099s to borrowers in these circumstances. This is so that the IRS will be able to keep track of whether the borrower properly reports the foreclosure or short sale transaction. However, the fact that a 1099 is issued doesn’t mean that the full amount shown -- or even any part of it -- is subject to capital gain or debt relief income tax.

The questions above explain various reasons why the foreclosure or short sale transaction do not result in taxable income. When a 1099 is received, it is important for the borrower to discuss the situation with a trained professional tax advisor. If the borrower prepares an income tax return by himself or herself, there is a good chance that the amounts shown in the 1099 won’t be handled correctly, resulting in the borrower paying too much income tax; being selected for an audit; having to pay penalties and interest; and other consequences.

**Q 16.** *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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Readers who require specific advice should consult an attorney.

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The information contained herein is believed accurate as of July 20, 2005. It is intended to provide general answers to general questions and is not intended as a substitute for individual legal advice. Advice in specific situations may differ depending upon a wide variety of factors. Therefore, readers with specific legal questions should seek the advice of an attorney.