

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 2. *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 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" income. Whether the owner is subject to taxation on this 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.

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 6. 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, there will be no taxation on this forgiveness of debt (cancellation of debt) 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
<u>Less Adjusted Basis</u>	<u>\$200,000</u>
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
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<u>Less FMV</u>	<u>\$250,000</u>
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
<u>Less Adjusted Basis</u>	<u>\$200,000</u>
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.

Q 7. *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
<u>Less Adjusted Basis</u>	<u>\$200,000</u>
Capital Gains	\$100,000

Q 8. 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

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, 2010.

****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.

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.

(26 U.S.C. §§108(a), 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?

	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 "Qualified Principal Residence Indebtedness" (**See the discussion in Question 9)

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

A Currently California follows the debt relief exemptions set forth in Question 10. However, the Franchise Tax Board has announced that California does not at this time follow the debt relief exemption provided by the Mortgage Forgiveness Debt Relief Act of 2007. There is pending California legislation, Senate Bill 1055, which would provide modified conformity to certain provisions of the Debt Relief Act.

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.