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TAX CONSEQUENCES OF FORECLOSURES, SHORT SALES, & ABANDONMENTS

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Waves of foreclosure continue to sweep our homes as low teaser rates expire and adjustable mortgage rates reset. Let's discuss tax implications of foreclosures, short sales, abandonment, and cancellation of debt. You could lose your home and incur capital loss, yet end up with taxable income from debt relief.

Let's assume that the borrower has stopped making payments and in response to this, the lender takes steps to take back the property; hence, the foreclosure proceedings.

1. First, let us get some definitions straight:
 - A. The **mortgagor** is you, the borrower paying on the loan.
 - B. The **mortgagee** is the bank or the seller collecting on your loan.
 - C. **Foreclosure** occurs when the bank takes the property back.
 - D. **Repossession** occurs when the seller takes the property back.
2. Your liability to the lender depends on the type of loan - mortgage or deed of trust:
 - A. Under a **mortgage**, the individual secures the note. Foreclosure does not end your liability if the subsequent sale is not adequate to pay off your loan.
 - B. Under a **deed of trust**, property secures the note. Foreclosure ends your liability. California uses the trust deed method, not the mortgage method. Thank you.
 - C. Be careful when deciding to refinance: a non-recourse purchase money loan converts to recourse if refinanced. This is not good. New 2nd mortgages or equity lines of credit are recourse loans.
3. After you stop making payments on a loan and give your property back to the lender, there is a **disposition of property** that must be reported to the government.
4. Your main problem is determining the **sales price** of the property. This will either be the fair market value (FMV) or the balance of the loan depending on whether it is a recourse or non-recourse loan. (We will discuss recourse loans later to get your undivided attention at this time).
5. Foreclosures produce two types of income:
 - A. **Gain or loss on disposition**: You have disposed of a property and in effect, a sale has taken place. The character of the underlying gain can be either ordinary or capital, whereas the character of the loss may be capital, ordinary or simply non-deductible.
 - B. **Debt relief income**: Debt relief is always ordinary income.
6. Debt relief transactions result in different sales prices based on whether your loan is recourse or non-recourse:
 - A. **Recourse** loans allow the lender to come after you for the full balance of the loan. If the subsequent selling price is not sufficient to pay off your loan, the lender has the right to collect the remainder from you. If the lender forgives the debt, there is debt relief and ordinary income.
 - B. **Non-recourse loans** do not give the lender the right to come after you for deficiency. If the property value is not sufficient, the lender has no recourse to come after you personally.
7. The following transactions can produce debt relief:
 - A. **Foreclosure**.
 - B. **Abandonment** (same as foreclosures for tax purposes).
 - C. **Voluntary reconveyance** wherein you negotiate with the bank for them to take the title back. It is different from foreclosure because the FMV may exceed the loan balance but not enough to warrant a sale. You probably will come out short after paying sales expenses.

- D. **Short sale** wherein you find a buyer for your property but the price is too low to provide enough funds to satisfy the loan. The sales come up short. The lender agrees to accept the terms of the sale and not to pursue you for the balance of the loan.
 - E. **Renegotiations with the bank**. This always results in debt relief and ordinary income.
 - F. **Deeding the property to somebody else**. There are companies that take title and inform the lender that they have no intention of making payments on the loan but are actively pursuing to sell the property. They then ask the lender to accept a short sale. If the lender refuses, the company lets the lender to foreclose. You still have to report the sale for the amount of the loan balance. Does it affect your credit history? Perhaps, since the loan is still in your name. Consult your lawyer on the legality of this technique.
8. When a **recourse loan** is involved, the sales price of the property is its fair market value. The FMV can either be the appraisal value or sales proceeds if the property is actually resold. As mentioned, recourse loans generate debt relief income that must be reported on your income tax return as ordinary income.
9. When a **non-recourse loan** is involved, the sales price is the greater of the loan balance or FMV of the property. The loan balance usually exceeds the FMV; otherwise, you would not be in such a position. California is a non-recourse mortgage state; accordingly, purchase money loans are non-recourse. Refinance loans and equity loans are not. Consider this issue when applying for a refinance or a new loan.
10. If the property foreclosed is your **principal** residence, report the sale on Form 2119. If the foreclosed property is your **second** home, use Schedule D instead of Form 2119. If the loan is secured by business equipment such as car or warehouse equipment, use Form 4797.
11. If you **voluntarily convey your property back to the bank** without a formal foreclosure, you are deemed to have abandoned that property. This is sometimes called **deed in lieu of foreclosure**. This is not a foreclosure and the tax treatment is different:
- A. On recourse loans, the sales price is the lesser of the loan balance or appraisal.
 - B. On non-recourse loans, the sales price equals the loan balance.
 - C. If you abandon a property, the lender issues you a 1099-A for the abandonment of a secured property. If you have debt relief, the creditor issues a 1099-C for cancellation of debt.
12. When the **lender reduces non-recourse, under-secured, or purchase debt**, the debt reduction is treated as debt income relief. Remember that debt relief can occur without foreclosure. If you negotiate with a lender to rewrite the loan balance, the transaction produces debt relief whether or not the loan is recourse or non-recourse.
13. There are **exclusions that allow you not to report the debt relief as income**:
- A. Any debt forgiven under Chapters 7, 11 or 13 of the Bankruptcy Code is excludable from income.
 - B. Taxpayers who are insolvent are allowed to exclude debt relief from income to the extent of insolvency. (You are insolvent when your liability exceeds your assets).
 - C. Individuals and partnerships may exclude debt forgiveness from qualified real estate indebtedness in connection real property used in trade or business. This includes rental properties.

Unfortunately, we see our relatives and friends lose their homes. They also have to deal with taxable debt relief. Fortunately, The Mortgage Forgiveness Act of 2007 comes to the rescue by excluding income from debt forgiveness on your main home. It does not apply to vacation and 2nd homes.