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## ABCs OF FORECLOSURES, SHORT SALES, AND DEEDS IN LIEU

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The loss of our homes to foreclosure, short sale, or deed in lieu of foreclosure is akin to adding insult to injury - we lose our home and worry about lender repercussion, credit history, and tax consequences. Let's define and discuss tax consequences of foreclosure, short sale, and deed in lieu of foreclosures.

### Definitions

**Foreclosure:** Foreclosure is an involuntary process whereby a lender repossesses property that was pledged as collateral for a mortgage loan. Foreclosure can occur judicially (court action) or non-judicially (trustee sale).

**Short Sale:** A short sale occurs when an owner sells property for less than the debt owed on a property. The lender must consent to the sale and agree to accept less than the full loan amount and release the property from the mortgage lien.

**Deed in Lieu of Foreclosure:** A deed in lieu of foreclosure occurs when an owner conveys property to the existing lender in exchange for cancellation of the mortgage loan ("in lieu" of a foreclosure by the lender).

### Tax Consequences of Foreclosures, Short Sales, and Deeds in Lieu

Each of the above circumstances results in two potential taxable consequences to the owner:

1. Tax on capital gain and/or
2. Tax on cancelled/forgiven debt.

Whether we get hit by one or two of these taxes depend on whether the debt is recourse or non-recourse.

#### **Tax Consequences If Debt Is Recourse (Personal Liability to Borrower):**

There are two tax consequences:

1. **Capital gain** - the difference between the adjusted basis and the fair market value. You are taxed at the applicable capital gains rate of either 5% or 15% depending on your tax bracket.
2. **Debt Relief** - the difference between the debt and the fair market value. Cancellation or forgiveness of debt is taxed as ordinary income.

For example, you bought an apartment building for \$400,000 with a loan of \$350,000 many moons ago. The property appreciated in value to \$1 million so you obtained a second loan of \$850,000. Total outstanding loan balance is \$1.2 million. Let's assume that the adjusted basis is \$0 after you have fully depreciated the building. The two tax consequences if you have recourse loans are:

- **Capital gain** must be recognized on the difference between the fair market value of the property (\$1 million) and the adjusted basis (\$0). Hence, you must pay capital gains tax on the \$1 million.
- **Debt Relief** must also be recognized on the difference between the fair market value (\$1 million) and the debt (\$1.2 million). You must pay ordinary income tax on the \$200,000 cancelled debt at regular tax rates.

#### **Tax Consequences If Debt Is Non-Recourse (Borrower Not Personally Liable):**

1. **Capital gains:** This is the *only* tax consequence. Capital gain is the excess of your loans over your adjusted basis. In this case, it's the same difference between the fair market value of the property (\$1 million) and the adjusted basis (\$0).
2. **Debt Relief:** There is *no* tax on cancellation or forgiveness of debt for non-recourse loans. ☺

#### **In summary:**

- If the debt is **recourse**, you pay capital gains tax *and* ordinary income tax.
- If the debt is **non-recourse**, you pay capital gains *only*.