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## Taxation of Foreclosures and Short Sales

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### Introduction

This legal article discusses the income tax consequences to the borrower in the event of a foreclosure on the borrower's property, in the event the borrower transfers title to the lender as part of an agreement with 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.

There are generally two types of taxable income that can result from a foreclosure, deed-in-lieu of foreclosure, or a short sale: capital gains and forgiveness of debt income (also known as cancellation of debt—COD income). As a result of the recent dramatic increase in distressed properties, federal and state laws have been enacted which reduce or eliminate the tax liability for many borrowers and existing tax laws can provide some relief as well. While this article provides general information on the tax laws concerning this area, REALTORS® should always be sure to refer clients to seek appropriate guidance from a tax professional such as an accountant or attorney to discuss their potential tax liability.

### **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. In the current market many distressed properties have a junior lien with a lender which is different from the first lienholder, which is why deed-in-lieu of foreclosure solutions have not been that common.

**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's 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" (COD) income. Whether the owner is subject to taxation on COD 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 the following 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, (sometimes referred to as a "purchase money loan") under the law or
2. When the seller carries back financing for all or a portion of the purchase price of any real property.

3. Refinance loans or other credit used to refinance a purchase money loan, or subsequent refinances of a purchase money loan, that are executed on or after January 1, 2013. The nonrecourse protection also extends to any loan fees, costs, and related expenses incurred as part of the refinance. The "nonrecourse" protection, however, does not extend to any cash out in a refinance or to any new principal which is not applied to any obligation owed or to be owed under the purchase money loan, or to the fees, costs, or related expenses of the credit/refinance loan transaction.

(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.

4. When the lender(s) agree to a short sale of a 1-4 unit resident property. The lender(s) is prohibited from requesting or obtaining any deficiency if they agree to a short sale. (Cal. Code Civ. Proc. § 580e)

### **Q 5. What is "recourse" debt?**

**A** Under California law, a "recourse" debt is one in which none of the exemptions in Question 4 occurs.

Examples of recourse debt are refinances of existing mortgages (other than in question 4), 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.

## **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
Less Adjusted Basis	\$200,000
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
Less FMV	\$250,000
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.)

## 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
Less Adjusted Basis	\$200,000
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.)

**NON-RECOURSE 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
Less Adjusted Basis	\$200,000
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 Cancellation of Debt (COD) Income- Recourse Debt**

A short sale involving a recourse debt, 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" or COD income). The amount of the debt that the lender agrees to write off is treated as "ordinary income".

This forgiveness or cancellation of debt, which is treated as "ordinary income" under certain circumstances, may be subject to taxation. However, a claim of insolvency may provide relief from COD income (Question 10). Additionally, there may be capital gains realized. See Question 6 above.

### **COD Income, Capital Gains and California Code of Civil Procedure Sections 580b(a)(3) and 580e - Non-recourse Debt**

Notwithstanding the expiration of the California Mortgage Debt Forgiveness Law on January 1st, 2013 and the Federal Mortgage Debt Relief Act at the end of 2013, California Code of Civil Procedure sections 580b and 580e provide relief from COD income for purchase money loans. The IRS has provided two letters to Senator Boxer in response to her request for clarification of debt relief when the lender agrees to a short sale. In the first letter, dated September 19, 2013, the IRS addressed the provisions of CCP section 580e. Under CCP section 580e no deficiency shall be owed, collected, requested or rendered for any lender-approved short sale of a one to four unit dwelling.

The IRS, using the term "homeowner", stated that no COD income would result in a lender approved short sale because section 580e makes such loans non-recourse. The use of the term homeowner together with the reference to 580e, which does not differentiate between a homeowner (generally purchase money non-recourse debt) and a non-homeowner (generally non-purchase money recourse debt - see Questions 4 and 5) created questions about what the IRS meant. Was there no COD income for all short sales covered by 580e or only for homeowners?

After receiving comments from California tax practitioners and its own review of California law, the IRS has issued a clarification to its September 19, 2013 letter. The new IRS letter indicates that forgiven short sale debt is not subject to COD income only if it is non-recourse at its inception and that their prior letter was overly broad.

In their new April 29, 2014 letter (focusing now on CCP 580b), the IRS states that in order for a debt to be non-recourse at the time of the short sale, the original debt must be used to purchase or build a 1-4 principal residence or a refinance of such debt. As in the prior letter the IRS affirms that a lender's forgiveness of such debt in a short sale will not result in COD income, but instead will be treated as capital gains. And as before, single or joint tax filers selling a principal residence can use the appropriate \$250,000 or \$500,000 capital gains exclusion.

What changed is that a loan used to substantially improve the taxpayer's principal residence may now be treated as COD income instead of capital gains. Additionally, the IRS clarified that an investor's short sale debt will also be characterized by the nature of the debt at inception. If it was recourse debt (non-principal residence purchase) originally, it will remain recourse debt at the time of the short sale. This may be somewhat good news for investors who may prefer to have short sale debt treated as COD income rather than capital gains. COD income may be avoided under a claim of insolvency where capital gains cannot.

C.A.R. will continue to seek additional clarification about some issues not addressed, such as a taxpayer's reliance on the IRS's prior letter, and whether forgiven home improvement debt should not also be excluded from COD income. As always REALTORS® must advise their clients that they

cannot give tax advice and that the client should seek tax advice from a qualified tax professional. A [copy of the letter from the IRS](#) is available for reference.

As of the writing of this Q&A, the Franchise Tax Board has not responded to the second IRS letter. However, the FTB in a letter dated December 4, 2013, based on the original IRS guidance, confirmed that a California taxpayer selling in a short sale pursuant to CCP section 580e would not have COD income but could be subject to capital gains. See Question 7 above.

## 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?**

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	<b>Recourse Foreclosure/ Deed-in-Lieu</b>	<b>Nonrecourse Foreclosure/ Deed-in-Lieu/Short Sale of 1-4 Units</b>
<b>Capital Gains</b>	FMV Less Adjusted Basis	Greater of FMV or Outstanding Debt Less Adjusted Basis
<b>Ordinary Income</b>	Outstanding Debt Less FMV	No Ordinary Income

**Q 14. *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. For more information, see [IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments](#), and IRS Web page, [The Mortgage Forgiveness Debt Relief Act and Debt Cancellation](#). Note that as of January 4, 2013 the IRS publications have not been updated to reflect the extension of the federal debt relief law to 2014.
- 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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The information contained herein is believed accurate as of December 5, 2013. 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. Revised by Sanjay Wagle, Esq., and Howard Fallman, Esq.

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