

Tax Consequences of a "Short Sale" of Real Estate vs. Foreclosure

Our nation is now seeing the effects of tightening mortgage credit after a liberal period. With increases in interest rates for adjustable rate mortgages and the conversion to amortization of principal for interest-only (or negative amortization) loans, home values for homes favored by subprime borrowers (and even other homes) are collapsing, and the debtors are either trying to "walk away" from their homes and allowing them to be foreclosed or are making "short sales."

A "short sale" is selling the home for less than the mortgage balance and trying to get the lender to forgive the unpaid balance. This is a new use of the term, and is not the definition for this item in the Internal Revenue Code. In the tax law, a "short sale" is a sale of a borrowed item to be replaced at a future date, usually a security. The only case that I know about using the term "short sale" for this type of transaction is a 2008 decision, *Stevens v. Commissioner*.¹ With the explosion of real estate short sales, we will undoubtedly soon see more cases with them.

A reason for debtors to consider a "short sale" instead of a foreclosure is to try to protect their credit history.

How are foreclosures (and deeds in lieu of foreclosure) taxed?

An important consideration in the results of a foreclosure (or a deed in lieu of foreclosure) is whether the debt is "recourse" or "nonrecourse." If the debt is "recourse," the debtor is personally liable for the debt. If the debt is "nonrecourse," the debt is only secured by the property, and the debtor is not personally liable for the balance.

You should consult with an attorney to determine the status of your mortgage. In California, most mortgages that are used to purchase a residence are nonrecourse, but mortgages from refinancing a previous mortgage are usually recourse.

When a nonrecourse mortgage is foreclosed, the property is treated as being sold for the balance of the mortgage.² This is important because the gain from a foreclosure of a principal residence may be eligible for the \$250,000 (\$500,000 for jointly-owned marital property) exclusion.

For example, for foreclosure of a nonrecourse debt,

Nonrecourse debt	\$500,000
Tax basis (cost to determine tax gain or loss)	<u>300,000</u>
Gain	<u>\$200,000</u>

If the holding period requirements are met and the residence was a principal residence, the above gain would be tax-free.

(Note: The above example is for consistency and contrast with the results for recourse debt. Most non-recourse debt for a residence is purchase-money debt, and would not exceed the tax basis (purchase price) of the residence. When the residence was a replacement residence for a principal residence sold before May 7, 1997, the tax basis can be less than the cost of the residence. Most of the mortgages for residences acquired in that scenario have probably been refinanced and are now recourse debt.)

For recourse debt, the debt is only satisfied up to the fair market value of the property. There is a sale up to that amount. If the lender forgives the balance of the mortgage, there is *cancellation of debt income*, which is taxed as *ordinary income*.³ (Regulations § 1.61-12.) (But see tax relief enacted for certain recourse debt secured by a principal residence, below.)

For example, for foreclosure of a recourse debt,

Recourse debt	\$500,000
Fair market value	<u>450,000</u>
Cancellation of debt (ordinary income)	<u>\$ 50,000</u>

(If the cancellation of debt was for "qualified principal residence indebtedness," it will be excluded from taxable income. If the taxpayer still owns the home after the cancellation of debt, the excluded amount will be subtracted from the tax basis of the residence. See the section on "tax relief," below.)

Fair market value	\$450,000
Tax basis	<u>300,000</u>
Gain	<u>\$150,000</u>

Again, if the holding period requirements are met and the residence was a principal residence the above gain would be tax-free, but the cancellation of debt would generally be taxable as ordinary income, except for certain "qualified principal residence indebtedness." See the section on "tax relief," below.

Tax relief enacted for recourse mortgage on principal residence debt forgiveness.

Congress has passed and President Bush has approved H.R. 3648, the "Mortgage Forgiveness Debt Relief Act of 2007." The legislation is effective for discharges of indebtedness on or after January 1, 2007 and before January 1, 2010. The Federal Bailout Legislation H.R. 1424, passed on October 3, 2008, extended this relief through December 31, 2012.

Under the new law, a discharge of "qualified principal residence indebtedness" is excluded from taxable income. "Qualified principal residence indebtedness" is **acquisition indebtedness** secured by the principal residence of a taxpayer as defined for the deduction of residential mortgage interest, but the limit is \$2,000,000 for the exclusion (\$1,000,000 for the mortgage interest deduction) and \$1,000,000 for married persons filing a separate return (\$500,000 for the mortgage interest deduction). Also, the exclusion only applies to a mortgage secured by the principal residence of the taxpayer.

The election to exclude the income from discharge of principal residence indebtedness is made on Form 982 (Re. February 2008), Part I, lines 1.e and 2. According to IRS Publication 4681, a basis reduction amount is entered at Part II, like 10.b. only if the taxpayer still owns the residence after the debt cancellation.⁴ IRS Publications aren't considered legal authority and I haven't found any other authority for not making a basis adjustment when the debt cancellation happens at the same time as a foreclosure or short sale.

The exclusion does not apply if the discharge relates to providing services to the lender or any other factor not related to a decline in the value of the residence or the financial condition of the taxpayer/borrower.

According to IRS Publication 4681, if the taxpayer continues to own the home after the debt cancellation, the tax basis of the residence (cost used to determine taxable gain or loss on sale) is reduced by any amount of discharge of indebtedness excluded from taxable income, but not below zero. There is no basis adjustment if the debt cancellation happens with a foreclosure or short sale. There will be two calculations. (1) Cancellation of debt income eligible for exclusion. (2) Sale of residence to apply applicable exclusion.

The new exclusion of income for discharge of acquisition indebtedness for a principal residence takes precedence over the exclusion relating to insolvency (discussed below), unless the taxpayer elects otherwise.

For example, if the previous example for a recourse debt was eligible for the exclusion, here are the tax results:

Recourse debt	\$500,000
Fair market value	<u>450,000</u>
Cancellation of debt excluded from taxable income	<u>50,000</u>
Fair market value	\$450,000
Tax basis	300,000
Gain	<u>\$150,000</u>

If the holding period requirements are met, the above gain would qualify for the exclusion (\$500,000 married, joint or \$250,000 single) for sale of a principal residence.

(Remember the foreclosure of a non-recourse mortgage is *not* a discharge of indebtedness, but a "sale" of the residence in satisfaction of the mortgage. Therefore, such a foreclosure won't qualify for the new exclusion, but may qualify for the exclusion of gain for sale of a principal residence. Also, since the balance of acquisition indebtedness is almost always less than the tax basis (cost) of the residence, it would be highly unusual for there to be a gain from a foreclosure.)

[Disqualified debt taxable first.](#)

An "ordering rule" in the tax law says that the exclusion only applies to as much of the amount discharged as exceeds the amount of the loan which is not qualified principal residence indebtedness.⁵ The IRS explains how to apply the rule at Page 8 of Publication 4681.

For example, Julie Smith's residence was foreclosed in 2008. The fair market value of her home was \$200,000. The balance of her mortgage was \$275,000. Julie had used \$50,000 from refinancing her home to pay down her credit card debt, not for home improvements. \$50,000 of the debt discharge that is not qualified residence debt would be taxable, and the remaining \$25,000 that is qualified residence debt would be excluded from taxable income.

Another example, the residence of John and Mary Taxpayers was foreclosed in 2008. The fair market value of their home was \$1,500,000. The balance of their mortgage, which was all acquisition indebtedness, was \$2,250,000. Since the maximum qualified principal residence indebtedness is \$2,000,000, \$250,000 of the debt was not qualified principal residence indebtedness. The \$250,000 non-qualified debt cancellation would

be taxable income, and the remaining \$500,000 that is qualified indebtedness would be excluded from taxable income.

Amounts that are otherwise taxable in the above examples could qualify for exclusions under other exceptions, such as for insolvency or bankruptcy.

California extends debt cancellation tax relief for homeowners.

California has enacted relief legislation for cancellation of mortgage debt relating to the acquisition of a principal residence.

Governor Schwarzenegger signed SB 401 (Wolk), the Conformity Act of 2010, on April 12, 2010, while we tax return preparers were busy finishing income tax returns and extension forms.

Effective for taxable years 2009 through 2012, the maximum qualified principal residence indebtedness eligible for relief is \$400,000 for taxpayers who file as married or registered domestic partners filing a separate return and \$800,000 for taxpayers who file joint returns, single persons, head of household and qualifying widow or widower (other individual taxpayers). The federal limits are \$1 million for married persons filing a separate income tax return or \$2 million for other individual taxpayers.

The debt relief that can be excluded from taxable income is limited to \$250,000 for married or registered domestic partners filing a separate return and \$500,000 for other individual taxpayers. The federal exclusion is limited to the amount of qualified principal residence indebtedness.

Note that the amount that can be excluded from taxable income for California was increased compared to the amounts that could be excluded for 2007 or 2008, which was \$125,000 for married or registered domestic partners filing a separate return and \$250,000 for other individual taxpayers.

Those taxpayers who now qualify for relief for 2009 and who filed their 2009 California individual income tax returns should file amended returns, Form 540X, including an amended Schedule CA (540/540NR). When filing Form 540X, write "Mortgage Debt Relief" in red across the top of page one of Form 540X.

There is no California equivalent for Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness. Use the Federal form marked "California" at the top.

Remember the tax basis of the residence is reduced for the excluded gain.

What happens with a "short sale"?

Short sales are taxed under the same rules as foreclosures.

Recourse debt cancellation is not satisfied with the surrender of the property, so any debt not satisfied with the sale proceeds would be taxable as cancellation of debt income, except for certain "qualified principal residence indebtedness." See section on "tax relief" above. (Rev. Rul. 92-99, 1992-2 CB 518. Also see Treasury Regulations Section 1.1001-2(a)(2).)

Therefore, the tax consequences would be similar to the "recourse debt" example, above. The buyer and seller might also have legal concerns about whether the lender would consent to the transaction and whether (for recourse debt) the lender would in fact forgive the debt.

For example, for a recourse debt short sale,

Net sale proceeds	\$450,000
Tax basis	<u>300,000</u>
Gain	<u>\$150,000</u>
Debt	\$500,000
Pay off using net sale proceeds	<u>450,000</u>
Cancellation of debt (ordinary income)	<u>\$ 50,000</u>

(If the cancellation of debt was for "qualified principal residence indebtedness," it will be excluded from taxable income and be subtracted from the tax basis of the residence. See the section on "tax relief," above.)

For non-recourse debt short sales *when the seller and buyer require the cancellation of the debt by the lender as a condition of the sale*, the debt cancellation is included in the sale proceeds, like for a foreclosure.⁶

Therefore, a "short sale" can be a viable alternative to a foreclosure for debtors with nonrecourse debt and who qualify for the exclusion from income of the gain from the sale of a principal residence.

What about selling expenses for a recourse mortgage?

For simplicity, I have disregarded selling expenses in the above discussion. For a short sale, selling expenses reduce the sales proceeds available to reduce the loan. For a foreclosure or deed in lieu of foreclosure, selling expenses are added to the debt. (See *Jerry Myers Johnson v. Commissioner*, TC Memo 1999-162, affirmed CA-4, 2001-1 USTC ¶ 50,391.) The net result should be similar, assuming the fair market value of the property equals the selling price for a short sale.

For example, for foreclosure of a recourse debt,

Recourse mortgage balance	\$500,000
Selling expenses	<u>50,000</u>
Total debt	\$550,000
Fair market value	<u>450,000</u>
Cancellation of debt (ordinary income)	<u>\$100,000</u>

(If the cancellation of debt was for "qualified principal residence indebtedness," it will be excluded from taxable income. According to IRS Publication 4681, if the cancellation of indebtedness happened relating to a short sale, no basis adjustment would be required. If the taxpayer still owned the home after the debt cancellation, the exclusion amount would be subtracted from the tax basis of the residence. See the section on "tax relief," above.)

Fair market value	\$450,000
Tax basis	-300,000
Selling expenses	<u>-50,000</u>
Gain	<u>\$100,000</u>

For example, for a recourse debt short sale,

Sales price	\$450,000
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Selling expenses	-50,000
Tax basis	<u>-300,000</u>
Gain	<u>\$100,000</u>
Recourse mortgage balance	\$500,000
Pay off using net sale proceeds (\$450,000 sales price - \$50,000 selling expenses)	<u>400,000</u>
Cancellation of debt (ordinary income)	<u>\$100,000</u>

(Same caveat for "qualified principal residence indebtedness" as above.)

Other exceptions for cancellation of debt income.

Cancellation of debt income may not be taxable if the debtor is insolvent or has the debt discharged in bankruptcy.⁷ With recent changes in the federal bankruptcy laws, it is much harder for individuals to file bankruptcy than before the changes.

What if the fair market value of the home has dropped after purchase?

Example - Non-recourse foreclosure/short sale

Mortgage balance	\$500,000
Tax basis	<u>700,000</u>
Loss	<u>-\$200,000</u>

(The fair market value of the property is disregarded for a non-recourse mortgage.)

If this is a principal residence, the loss is a non-deductible personal loss.

Example – Recourse foreclosure/short sale

Mortgage balance	\$500,000
Fair market value	<u>450,000</u>
Cancellation of debt income	<u>\$ 50,000</u>

(But see the rules for exclusion for cancellation of "qualified principal residence indebtedness" in the section on "tax relief," above.)

Fair market value	\$450,000
Tax basis	<u>\$700,000</u>
Loss (for personal residence, non-deductible)	<u>-250,000</u>

Senator Grassley asks IRS to help homeowners with loan forgiveness tax bills.

Senator Chuck Grassley, R-Iowa, who is the ranking minority member on the Senate Finance Committee, has sent a letter to the Treasury Department and the Internal Revenue Service asking for help for homeowners who face big tax bills because of home loan debt forgiveness on a principal residence. Grassley asked that the IRS accept offers in compromise to eliminate or reduce the taxes for these transactions.

Grassley reminded the IRS that they may compromise to promote effective tax administration where compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for compromising the liability.

(Similar requests were ignored when taxpayers suffered tax disasters relating to stock option transactions during the stock market crash of 2000 and 2001.)

Considerations for rental real estate

Owners of rental properties often have accumulated suspended passive activity losses that can be applied against the income from a debt cancellation with respect to the rental.

Losses from the sale of income-producing properties may be deductible as ordinary losses under Internal Revenue Code Section 1231. (The loss is reported on Form 4797.) The loss may offset cancellation of debt income. If the property isn't income producing, the loss may be a capital loss, limited to capital gains plus \$3,000.

Taxpayers other than C corporations may elect to exclude cancellation of “qualified real property business indebtedness” from taxable income. (Internal Revenue Code Sections 108(a)(1)(D) and 108(c).) This is mostly debt incurred to acquire, construct, reconstruct or substantially improve real property used in a trade or business. (Rental real estate is *not* considered to be used in a trade or business.) Refinanced debt up to the qualifying amount of a previous debt also qualifies. The tax basis of depreciable real property is reduced for the excluded gain. The amount excluded is limited to the adjusted basis of depreciable real property before the discharge.

Exclusions for discharges of debt in bankruptcy in a title 11 case and up to the amount of insolvency are also available for cancellations of debt relating to investment real estate.

The tax basis of assets must be reduced for the excluded gain.

(Thanks to Richard Ogg, EA, who brought the *Briarpark* decision to my attention!)

P.S. For more information, watch Michael Gray's interviews of attorney William Mahan for the [Financial Insider Weekly, "How Mortgage Modifications, Short Sales and Foreclosures Work"](#) and ["Short Sales and Foreclosures - Tax Consequences."](#) Attorney Michael Malter of Binder & Malter, LLP also discusses short sales in Michael Gray's interview for *Financial Insider Weekly*, ["What you should know about bankruptcy for individuals"](#).

There are also explanations about foreclosures and cancellation of debt in IRS Publications 523, Selling Your Home; 552, Taxable and Nontaxable Income; and 544, Sales and Other Dispositions of Assets at www.irs.gov. Also see the instructions for Form 982. The IRS also recently issued IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions and Abandonments.

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