



# Tax Aspects of Foreclosures and “Short Sales”

BY DAVID M. FOGEL, EA, CPA

With the home mortgage crisis in full swing, one or more of your clients has probably received a Form 1099-A or 1099-C as a result of losing a home or other real property due to foreclosure, “short sale,” abandonment or deed in lieu of foreclosure. What do you report on the client’s tax return? The purpose of this article is to provide you with an overview of these transactions and the tax implications that can result.

## Background

In both a foreclosure and a “short sale,” the fair market value (FMV) of the property has fallen below the amount of the outstanding indebtedness owed to the lender and the borrower is in default on the loan.

In a foreclosure, the lender exercises its security interest in the property and takes the property. The property is sold at a foreclosure sale. If the amount received in the foreclosure sale does not fully satisfy the unpaid indebtedness, then the lender may or may not hold the borrower liable for the difference between the sales price and the unpaid indebtedness.

In a “short sale,” the property is sold to a third party at less than the balance of the indebtedness with the sale proceeds going to the lender. The lender usually cancels the balance of the indebtedness and releases its security interest in the property.

The indebtedness can be either nonrecourse or recourse. A debt is nonrecourse if the lender cannot hold the borrower personally liable for it and may go only against the value of the property that is securing the debt in order to collect. In California, an example of a nonrecourse debt is a purchase money mortgage, where the borrowed funds are used to purchase the property.

A debt is recourse if the lender can hold the borrower personally liable for it beyond the value of the property that is securing the debt. In California, examples of recourse debts that are secured by a real property include a second mortgage, a refinance loan, and a line-of-credit loan.

Abandonment occurs when the owner “walks

away” from the property and the lender is forced to foreclose to satisfy the debt. A deed in lieu of foreclosure occurs when the borrower agrees to surrender the property to the lender in satisfaction of the debt. Both of these transactions are treated as foreclosures.

In general, transactions in which the lender agrees to work with the borrower (“short sale” and deed in lieu of foreclosure) do less damage to the borrower’s credit rating and are preferable to foreclosure or abandonment.



## IRS Forms

Forms 1099-A and/or 1099-C (see illustrations on following pages) are issued by lenders to report the income tax consequences of a foreclosure, “short sale,” abandonment, etc. If the lender acquires the

property and does not cancel any debt, then Form 1099-A will be issued.<sup>1</sup> If the lender cancels part or all of the debt, then Form 1099-C will be issued.<sup>2</sup> A lender who cancels a debt in connection with a foreclosure or abandonment may file Form 1099-C instead of Form 1099-A.<sup>3</sup>

## Tax Consequences of Foreclosures and “Short Sales”

If a lender discharges any part of a debt, then the taxpayer must recognize the amount discharged as ordinary income.<sup>4</sup>

The U.S. Supreme Court has held that when a nonrecourse debt is canceled in exchange for a transfer of the property securing the debt, the transfer is treated as a sale or exchange of the property and the amount realized from the sale equals the amount of the debt even if it exceeds the FMV of the property.<sup>5</sup> The amount realized from the sale includes the greater of the sales price of the property or the unpaid balance of the debt.

However, where the unpaid indebtedness is recourse, the transaction is split into two parts: (1) a taxable disposition of the property, and (2) to the extent the FMV of the property is less than the unpaid indebtedness, either a continuing debt obligation is owed to the lender or the remainder of the debt is discharged.<sup>6</sup> The gain or loss on the taxable disposition portion

CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code		OMB No. 1545-1424  <span style="font-size: 2em; font-weight: bold;">2008</span>  Form <b>1099-C</b>		
CREDITOR'S federal identification number	DEBTOR'S identification number	1 Date canceled	2 Amount of debt canceled \$	
DEBTOR'S name  Street address (including apt. no.)  City, state, and ZIP code		3 Interest if included in box 2 \$	4	<b>Copy B For Debtor</b> This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Account number (see instructions)		5 Debt description	6 Bankruptcy (if checked) <input type="checkbox"/>	
		7 Fair market value of property \$		

Form **1099-C** (keep for your records) Department of the Treasury - Internal Revenue Service

is equal to the difference between the property's FMV and the taxpayer's adjusted basis. If the lender cancels the remainder of the debt, then the borrower will have income from discharge of indebtedness equal to the difference between the principal amount of the debt and the property's FMV.

If the borrower qualifies, he or she may be able to use one of the relief provisions available in IRC §108 to exclude the income from discharge of indebtedness from gross income. Examples include the bankruptcy exclusion, the insolvency exclusion, the exclusion for qualified real property business indebtedness, and the principal residence exclusion. A taxpayer who excludes income from discharge of indebtedness under IRC §108 should file Form 982 with the return.

Under the bankruptcy exclusion, the income may be excluded from gross income if the discharged debt occurred as a result of a bankruptcy.<sup>7</sup> Under the insolvency exclusion, the income may be excluded from gross income to the extent of the amount of the taxpayer's insolvency.<sup>8</sup>

Under the business indebtedness exclusion, the income may be excluded from gross income and applied, instead, to reduce the taxpayer's adjusted basis of the property if certain requirements are satisfied.<sup>9</sup> The exclusion is limited to the principal amount of the debt over the FMV of the property.<sup>10</sup>

On December 20, 2007, the President signed the Mortgage Forgiveness Debt Relief Act of 2007.<sup>11</sup> This act allows a taxpayer to exclude, for federal income tax purposes, up to \$2 million (\$1 million in the case of a married person filing a separate return) of income from the discharge of indebtedness where the debt was secured by the taxpayer's principal residence. Under this act, the relief is available for discharges of debt that occur during 2007 through 2012.<sup>12</sup>

To qualify for this exclusion, the indebtedness discharged must be "Qualified Personal Residence Indebtedness."<sup>13</sup> "Qualified Personal Residence Indebtedness" for purposes of IRC §108 is defined as "acquisition indebtedness

within the meaning of section 163(h)(3)(B)...with respect to the principal residence of the taxpayer."<sup>14</sup> "Acquisition indebtedness" means any indebtedness which is incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer which is secured by the residence.<sup>15</sup> It does not include "Home Equity Indebtedness" described in IRC §163(h)(3)(C).

Refinancing indebtedness also qualifies as "Acquisition Indebtedness," but only to the extent that it doesn't exceed the refinanced indebtedness (the principal balance of the debt paid off by the refinance loan).<sup>16</sup> To the extent that the proceeds from the refinance loan are used to substantially improve the residence, that portion will qualify as "Acquisition Indebtedness."<sup>17</sup> However, if the proceeds from the refinance loan are not used to substantially improve the residence, that portion may qualify, instead, as "Home Equity Indebtedness" under IRC §163(h)(3)(C), but it won't be eligible for the exclusion under IRC §108(a)(1)(E).

Under an ordering rule, if only a portion of the discharged debt represents "Qualified Principal Residence Indebtedness," then relief will apply only to the portion of the loan discharged that exceeds the loan that is not "Qualified Principal Residence Indebtedness."<sup>18</sup> In other words, if the taxpayer refinanced the original mortgage loan and used the proceeds for purposes other than acquiring, constructing or improving the residence (such as paying off credit cards), then only the portion of the refinance loan that exceeds the nonqualified portion is eligible for relief.

On September 25, 2008, Governor Schwarzenegger signed Senate Bill 1055, partially conforming California law to the Mortgage Forgiveness Debt Relief Act of 2007. SB 1055 allows a taxpayer to exclude up to \$250,000 of income from the discharge of indebtedness for a maximum debt of \$800,000 secured by the taxpayer's principal residence (these numbers are halved for a married individual filing a separate return). The relief is available for discharges of debt that occurred during 2007 and 2008 only.

CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no.		OMB No. 1545-0877	<div style="border: 2px solid blue; border-radius: 50%; padding: 5px; display: inline-block;"> <b>Acquisition or Abandonment of Secured Property</b>  <b>2008</b>                      Form 1099-A                 </div>
LENDER'S federal identification number	BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment	
BORROWER'S name		2 Balance of principal outstanding	<b>Copy B For Borrower</b> This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.)		3 [REDACTED]	
City, state, and ZIP code		4 Fair market value of property	
Account number (see instructions)		5 Was borrower personally liable for repayment of the debt? <input type="checkbox"/> Yes <input type="checkbox"/> No	
		6 Description of property	

Form 1099-A
(keep for your records)
Department of the Treasury - Internal Revenue Service

## Examples

A few examples will illustrate the application of these rules.

### Example 1

In May 2006, Mr. and Mrs. Anderson purchased a personal residence in Sacramento for \$470,000, paying \$40,000 down and obtaining a nonrecourse mortgage loan of \$430,000.

In July 2008, the FMV of the residence had fallen to \$310,000. The principal amount owed on the mortgage loan was \$415,000 and the Andersons were in default. The lender foreclosed and acquired the residence. The lender issued Form 1099-A to report the foreclosure.

As a result of this transaction, the Andersons had no income from discharge of indebtedness because the indebtedness was nonrecourse. Rather, they had a nondeductible loss on the sale of their residence of \$55,000 (sales price of \$415,000 minus cost basis of \$470,000).

### Example 2

In April 2006, Mr. and Mrs. Burke purchased a personal residence in Sacramento for \$440,000, paying \$30,000 down and obtaining a nonrecourse mortgage loan of \$410,000. In January 2007, when the value of the residence had risen to \$500,000 and the principal balance of the mortgage loan was \$405,000, they refinanced the mortgage loan for \$460,000 and used the \$55,000 in proceeds to make improvements to the residence.

In October 2008, the FMV of the residence had fallen to \$320,000. The principal amount owed on the mortgage loan was \$450,000 and the Burkes were in default. The mortgage loan had become a recourse loan because it resulted from a refinance. The lender agreed to a "short sale" in which the Burkes sold the residence to a third party with the proceeds going to the lender. The lender agreed to cancel the balance owed on the mortgage loan. The lender issued Form 1099-C reporting \$130,000 (\$450,000 principal balance of mortgage loan minus

\$320,000 FMV of residence) in box 2 as the amount of the debt that was canceled.

As a result of this transaction, the Burkes had income from discharge of indebtedness of \$130,000. They also had a loss on the sale of their residence of \$175,000 — sale price of \$320,000 minus cost basis of \$495,000 (\$440,000 cost plus \$55,000 improvements).

Under both the Mortgage Forgiveness Debt Relief Act of 2007 and SB 1055, the Burkes will be able to exclude the entire \$130,000 income from discharge of indebtedness from their gross income. The Burkes should include Form 982 with their 2008 tax return to claim the exclusion. The \$175,000 loss on the sale of their residence is not deductible because it constitutes a personal loss.

Although IRC § 163(h)(3)(B) provides that refinancing indebtedness qualifies as "acquisition indebtedness," but only to the extent that it doesn't exceed the principal balance of the debt paid off by the refinance loan, in this example, the proceeds from the refinance were used to substantially improve the Burkes' residence. Therefore, the entire refinance loan qualifies as "Acquisition Indebtedness" and therefore, the entire \$130,000 income from discharge of indebtedness qualifies for the IRC § 108(a)(1)(E) exclusion.

### Example 3

In December 2005, Mr. and Mrs. Casey purchased a personal residence in Sacramento for \$470,000, paying \$40,000 down and obtaining a nonrecourse mortgage loan of \$430,000. In February 2007, when the value of the residence had risen to \$550,000 and the principal balance of the mortgage loan was \$420,000, they refinanced the mortgage loan for \$500,000 and used all of the proceeds to pay off credit cards.

In December 2007, the FMV of the residence had fallen to \$420,000. The principal amount owed on the mortgage loan was \$490,000 and the Caseys were in default. The mortgage loan had become a recourse loan because it resulted from a refinance. The lender foreclosed and acquired the residence. The lender issued



Form 1099-A to report the foreclosure. In June 2008, the FMV of the residence had fallen even further to \$380,000. The lender decided to cancel the balance owed on the mortgage loan. The lender issued Form 1099-C reporting \$110,000 (\$490,000 principal balance of mortgage loan minus \$380,000 FMV of residence) in box 2 as the amount of the debt that was canceled.

As a result of this transaction, the Caseys had a nondeductible 2007 loss on the foreclosure of their residence of \$50,000 (FMV of \$420,000 minus cost basis of \$470,000). There was no income from discharge of indebtedness because the lender had not yet canceled any portion of the mortgage loan. In 2008, the lender canceled the balance of the mortgage loan, so the Caseys had income from discharge of indebtedness of \$110,000.

As explained below, under both the Mortgage Forgiveness Debt Relief Act of 2007 and SB 1055, the Caseys will only be able to exclude from their 2008 gross income \$30,000 of the \$110,000 income from discharge of indebtedness. The Caseys should include Form 982 with their 2008 tax return to claim the exclusion.

\$80,000 of the \$110,000 income from discharge of indebtedness is not eligible for the exclusion because this portion does not qualify as "acquisition indebtedness." As mentioned above, IRC § 163(h)(3)(B) provides that refinancing indebtedness qualifies as "acquisition indebtedness," but only to the extent that it doesn't exceed the principal balance of the debt paid off by the refinance loan or if the proceeds from the refinance were used to substantially improve the residence. In this example, since the original loan was \$420,000 at the time it was refinanced for \$500,000, and since none of the proceeds from the refinance were used to substantially improve the residence, the difference (\$80,000) does not constitute "acquisition indebtedness" under IRC § 163(h)(3)(B). Rather, it constitutes "home equity indebtedness" under IRC § 163(h)(3)(C), which is not eligible for the IRC § 108(a)(1)(E) exclusion.

Applying the ordering rule of IRC § 108(h)(4) yields the same result. Under this rule, if only a portion of the discharged debt represents "Qualified Principal Residence Indebtedness," then the IRC § 108(a)(1)(E) exclusion will apply only to the portion of the loan discharged that exceeds the loan that is not "Qualified Principal Residence Indebtedness." In this example, the portion of the loan discharged was \$110,000. "Qualified Principal Residence Indebtedness" for purposes of IRC § 108 includes only "acquisition indebtedness" under IRC § 163(h)(3)(B). Since \$420,000 of the loan is "acquisition indebtedness" and \$80,000 is "home equity indebtedness," the portion of the loan that is not "Qualified Principal Residence Indebtedness" is \$80,000. As a result, the IRC § 108(a)(1)(E) exclusion will apply only to \$30,000 (the excess of \$110,000 over \$80,000), and therefore, the \$80,000 income from discharge of indebtedness is not eligible for the exclusion.

In each of the examples discussed above, pursuant to IRC § 108(h)(1), the taxpayer's basis in the residence should be reduced by the amount of income excluded under section 108.

## Conclusion

The tax aspects of foreclosures, "short sales" and abandonments depend upon many variables, such as whether the lender cancels the debt and whether the debt is recourse or nonrecourse. And as shown in the examples, they can get quite complicated. If the lender cancels the debt, the client may be entitled to exclude the income resulting from such cancellation under IRC § 108. Understanding how to apply these rules is crucial to determining the tax implications.

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<sup>1</sup> IRC § 6050J.

<sup>2</sup> IRC § 6050P.

<sup>3</sup> Treas. Reg. § 1.6050P-1(e)(3).

<sup>4</sup> IRC § 61(a)(12).

<sup>5</sup> *Commissioner v. Tufts*, 461 U.S. 300 (1983). See also Treas. Reg. § 1.1001-2(a)(1).

<sup>6</sup> Treas. Reg. § 1.1001-2(a)(2). See also Treas. Reg. § 1.1001-2(c), Example (8); and Revenue Ruling 90-16, 1990-1 C.B. 12.

<sup>7</sup> IRC § 108(a)(1)(A).

<sup>8</sup> IRC §§ 108(a)(1)(B) and (a)(3).

<sup>9</sup> IRC § 108(c)(1), (3) and (4).

<sup>10</sup> IRC § 108(c)(2).

<sup>11</sup> Pub. Law No. 110-142, H.R. 3648.

<sup>12</sup> The Mortgage Forgiveness Debt Relief Act of 2007 made this exclusion available for 2007, 2008 and 2009. See Act § 102(d) and IRC § 108(a)(1)(E). The exclusion was extended through 2012 by § 303 of the Emergency Economic Stabilization Act of 2008 (Pub. Law No. 110-343, H.R. 1424).

<sup>13</sup> IRC § 108(a)(1)(E).

<sup>14</sup> IRC § 108(h)(2). This definition is different than the definition of "Qualified Residence Interest" used in IRC § 163(h)(3).

<sup>15</sup> IRC § 163(h)(3)(B).

<sup>16</sup> IRC § 163(h)(3)(B).

<sup>17</sup> See H. Rept. No. 100-391, Omnibus Reconciliation Act of 1987 (P.L. 100-203), 10/19/87.

<sup>18</sup> IRC § 108(h)(4).

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