



How Short Payoffs and Foreclosures are Taxed

Foreclosures and sales involving property that is worth less than the debt it secures seem to be facts of economic life lately. In recent years, foreclosures, short sales, and other distress transactions have become a regular part of the real estate market. Still, it comes as a surprise to many people that a property owner can actually lose a property through foreclosure and be liable for payment of income tax on the foreclosure. The same is true when a property is sold in a “short sale” in which the lender accepts less than the full amount due. Surprise or not, it is true that two types of income can result from a foreclosure or short sale: capital gain or loss, and relief of indebtedness income. This following Legal Brief discusses the income tax consequences of foreclosure and the sales in the balance due on the loan as payment in full.

Q *What are the federal income tax results of a foreclosure?*

A A completed foreclosure is treated the same as a sale for income tax purposes. It is reported on the taxpayer’s tax return as a sale or exchange in the year the foreclosure is finalized. As with other sales, a foreclosure can result in either gain or loss. Gain or loss is the difference between net foreclosure proceeds and the borrower’s adjusted basis in the foreclosed property. “Basis” is usually the amount the taxpayer paid for the property when it was purchased. “Adjusted basis” means basis, plus the cost of improvements added to the property minus depreciation. If the seller did not acquire the property by purchase, basis is calculated differently.

Q *What are the federal tax results of a short sale?*

A A short sale can result in both capital gain or loss, and relief of debt income. These are calculated separately.

Q *What are the capital and ordinary assets?*

A If property is held for a purpose other than resale or inventory, it is generally considered a “capital asset.” There is no such thing as “debt relief” loss. Gain or loss on the sale of capital assets is called capital gain or capital loss. An example of a capital asset is a personal residence. Gain or loss on the sale of inventory is called ordinary gain or loss. An example of property held for resale is lots or subdivision units held by the developer.





Q *How is capital gain or loss calculated in a foreclosure or short sale?*

A Capital gain or loss is the difference between the taxpayer's basis in a capital asset and the price the property sells for at the foreclosure sale or short sale. If the basis is greater than the foreclosure or short sale price, the difference is capital gain, and is generally taxable. If the basis is less than the foreclosure sales price, the difference is capital loss. Capital loss on business or investment property can offset other types of income and lower the taxpayer's taxes for the year in which the foreclosure occurs. However, capital loss on personal use property, such as the taxpayer's residence, cannot offset other types of income and gives the taxpayer no benefit.

Q *What if the borrower pays a debt off at a discount?*

A If the lender accepts less than the full balance to mark the loan paid in full, the difference between the loan balance and the amount paid is debt relief income. Debt relief income is taxable as ordinary income.

Q *What about debt relief on recourse debt?*

A If the borrower is not personally liable for the debt (also called "non-recourse debt"), there is no debt relief income to be taxed. For a non-recourse debt, the principal balance of the loan at the time of the foreclosure is considered the amount realized on the sale, even if the value of the property is less than the principal of the value of the loan.

Q *What is debt relief income?*

A Debt relief income is also called cancellation of debt (COD) income. Debt relief in distressed real estate situations can result from:

- Debt restructuring that results in reduction of the amount of a recourse or non-recourse debt.
- Transfer of the property to a lender, that is accepted by the lender in full satisfaction of the debt even though the property is worth less than the balance of the debt. This includes transfers, sale under power of sale in a deed of trust, judicial foreclosure, and other conveyances.

For more information about this subject please contact:

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