

# IMPORTANT REAL ESTATE INFO

WEDNESDAY, APRIL 1, 2009

## Tax Consequences of a Short Sale, Foreclosure, or Deed in Lieu of Foreclosure

I have done a fair amount of research into the potential tax consequences of a Short Sale, Foreclosure, or Deed in Lieu of Foreclosure. There seems to be a lot of confusion about it, even among CPAs and other tax professionals. Hopefully this will clarify things a little bit. **DISCLAIMER:** I am not a CPA so make sure to consult your tax professional.

### Deficiency Judgments

Before even worrying about the tax consequences, you should initially understand the potential liability to your lender. The lender may be able to pursue a "deficiency judgment" against you for their loss. That means that the lender could sue you for the amount of their loss, and get a judgment against you for that amount. Then they could pursue the judgment through standard collection procedures such as attempting to garnish your wages.

Some states do not allow deficiency judgments. (For example, in Arizona, a lender cannot pursue a deficiency judgment against a borrower if the property is 2 units or less, on 2.5 acres or less, even if it's an investment property. That accounts for the large majority of single family homes, so there are very few deficiency judgments on single family homes in Arizona.) In most states, a deficiency judgment is allowed on investment properties.

Here are some examples of liability you might have to the lender:

1. **Foreclosure:** If you owe \$100,000, and the lender forecloses and takes your house back, and then sells it for \$50,000, they may consider that a \$50,000 loss. The lender could pursue a judgment against you for the \$50,000 since you agreed to pay them back for the whole \$100,000 when you borrowed the money. Generally the lender does not pursue a deficiency judgment in the case of a foreclosure, because they know that foreclosed borrowers don't have money, so it is not cost effective for them to pursue the money. But they may have the right to, depending on state law, and they may well pursue it.
2. **Short Sale:** If you owe \$100,000, and the lender agrees to take a \$50,000 payoff in a short sale, they would have a \$50,000 loss. The lender could pursue a judgment against you for \$50,000 since you agreed to pay them back for the whole \$100,000 when you borrowed the money. Generally in a short sale, the lender agrees to NOT pursue a deficiency judgment, since you are helping

### [Real Estate Crm System](#)

How to choose and setup a real estate database to grow profits

### [24 Closed Real Estate Sales](#)

Generate Enough Real Estate Leads To Close At Least 24 Sales This Year!

### [Real Estate Agent Success](#)

101 ways to a six figure income as a real estate agent. Learn how today.

them out by not extending the foreclosure proceeding.

- Deed in lieu of Foreclosure:** If you owe \$100,000, and the lender agrees to take your house back, rather than foreclosing, and they then sell it for \$50,000, they would have a \$50,000 loss. The lender could pursue a judgment against you since you agreed to pay them back the whole \$100,000 when you borrowed the money. Generally the lender does NOT pursue a deficiency judgment in the case of a deed in lieu of foreclosure, for the same reason as in the foreclosure -- they know that the borrower doesn't have much money, so it is not cost effective for them to pursue the judgment, and also the same reason as in a short sale -- you are helping them out by not extending the foreclosure proceeding, so they agree not to pursue the difference.
- Loan Modification:** If you owe \$100,000, and the lender agrees to reduce your loan balance to \$50,000, they would have a \$50,000 loss. In a loan modification, the lender will not pursue a deficiency judgment.

## Tax Consequences

Although the potential liability to the lender differs in each case, most people don't realize that the potential tax consequences of these events are essentially the same! The tax consequences arise from the fact that the IRS considers the amount of the debt that you didn't repay as income to you. For example, if you owe \$100,000, and the lender accepts a payoff of \$50,000 in a short sale, then the lender has canceled \$50,000 of your debt. The IRS would say that you have \$50,000 in income. (NOTE: If the lender gets a deficiency judgment against you, then they cannot also claim a tax loss for the same amount. They have to choose one or the other.)

If the sale was of your primary residence, then you may be exempt from paying taxes on the gain thanks to President Bush and the Mortgage Debt Relief Act of 2007. From the [IRS website](#): "The Mortgage Debt Relief Act of 2007 generally allows taxpayers to exclude income from the discharge of debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief. This provision applies to debt forgiven in calendar years 2007 through 2012."

However, if you are not able to exclude the income through the Mortgage Debt Relief Act (for example if the property was not your principal residence), then you may have to pay taxes on the gain, even though you did not receive any money. That is why it is referred to as a "phantom gain".

If your home was worth over \$100,000, then the \$50,000 income would be considered "capital gains". If the home was worth less than \$50,000, then the income would be considered "cancellation of debt" income (COD Income). If your home was worth between \$50,000 and \$100,000, then part of the income would be considered capital gains, and part of the income would be considered COD Income. For example, if the fair market value of the home was \$80,000, then you would have \$30,000 in capital gains and \$20,000 in COD Income.

The IRS knows about your phantom gain because the lender sends them a form

### [Tax Debt Relief Specialists](#)

Guaranteed, Trusted, Quick Results. Tax Debt Specialists, 888-260-2403.

[CTRTaxRelief.com/irs-taxes](http://CTRTaxRelief.com/irs-taxes)

### [Solve Your IRS Tax Debt](#)

Tax Debt, Levy, Settlement Services Experienced Tax Experts to Help You [taxcrisis.com](http://taxcrisis.com)

### [Stop Foreclosure "2011"](#)

Do you Qualify? Find out today. Free 60-second evaluation [LoanModificationHelpline.org/S](http://LoanModificationHelpline.org/S)

### [IRS Offer in Compromise](#)

Let Professionals Settle Tax Debt Get Facts-Do You Qualify- Member BBB [www.FinancialFirebird.com](http://www.FinancialFirebird.com)

### [Ask a Foreclosure Lawyer](#)

14 Foreclosure Lawyers Are Online! Foreclosure Law Answers Today: 17. [Law.JustAnswer.com/Foreclosure](http://Law.JustAnswer.com/Foreclosure)

### [Subscribe](#)

Enter your email address to receive notifications when there are new posts

[Sign Up](#)

Powered by [BLOG ALERT](#)

#### PREVIOUS POSTS

[What is my Tax Basis?](#)

[Details of the \\$8,000 tax credit for first time ho...](#)

[Go Renter Sucks](#)

[Section 179 Deductions](#)

[Credit Score Breakdown](#)

[It is IMPOSSIBLE to violate a "Due on Sale" clause...](#)

[Buying Bank Owned Properties \(REOs\)](#)

called a **1099-C**, which shows the amount of canceled debt income. On that form, the lender states what they think the fair market value of the home is. That number is not set in stone. You can use a different value when filing your taxes. But you need to justify the value that you select, for example by including comparable sales from the area. Include a note explaining what you did and why.

In many cases, the lender will fail to send out the **1099-C**. In that case, you still have to report the income, but you have more discretion in determining the fair market value. Of course you still need to justify the value that you select.

In most cases, it is to your advantage to treat the income as COD Income, because you can often qualify to get the tax on the COD Income waived. However, if you do not qualify to get the COD Income waived, then you will probably pay less in taxes if the income is treated as capital gains (assuming you owned the property for more than 365 days, which makes it "long term" capital gains).

## HOW DO I GET CANCELLATION OF DEBT INCOME WAIVED?

If you are not able to exclude the COD income through the Mortgage Debt Relief Act, then there are 3 primary ways or "exceptions" that allow you to get COD Income waived.

### 1 - Insolvency Exception

If you are insolvent, then you do not have to pay taxes on the COD Income.

Insolvency means that your debts are greater than your assets, or in other words, you have a negative net worth. When using the Insolvency exception, you can only get COD Income waived "to the extent that your liabilities exceeded the fair market value of your assets immediately before the cancellation." For example, if you had \$50,000 in COD Income, and your net worth was zero before the COD Income, then you would get 100% of the COD Income waived, but if your net worth was \$20,000, then you could only get \$30,000 of the COD Income waived.

To claim insolvency, include [IRS Form 982](#) when filing your taxes.

### 2 - Qualified Real Property Debt Exception

To qualify for the Qualified Real Property Debt Exception, you have to meet all of the following:

1. The property must have been used in a trade or business (not a primary residence or passive "investment"). This is a pretty gray issue, but if you have some activity relating to the property then it can probably be considered a trade or business. It doesn't have to be a real estate trade or business. As a landlord you can be considered to be in a trade or business if you were actively involved in the management of the property.
2. The debt must be secured by real property, and the debt has to be recorded ("perfected").
3. You must make the proper election on [IRS Form 982](#) when filing your taxes, and it must be filed with the original income tax return relating to the COD

[Real Estate Accounting Tips](#)

[How to Change Real Estate Companies in Arizona](#)

---

#### LINKS

**Bluehost.com:** Host unlimited domains on one account for only \$6.95 per month!

**Amazon.com**

**Cash Back Credit Cards**



Subscribe to Posts [[Atom](#)]

Income.

4. You must have used the debt to acquire, construct, or improve the property. If you refinanced and pulled out money for something besides the property, then you can't use this exception.
5. The maximum amount you can exclude is equal to the LESSER of either:
  1. Your [tax basis in the property](#) (So if you've been depreciating the property for many years, then you might not be able to exclude much of your COD Income through this exception.)
  2. The balance of the debt less the fair market value of the property secured by the debt. (For example if you owe \$100,000, and the fair market value of the property is \$80,000, then you could only exclude \$20,000 of COD Income.)

If this exception gives you a partial reduction in tax liability, you can still use other exclusions to further reduce your liability.

To claim the Qualified Real Property Debt Exception, include [IRS Form 982](#) when filing your taxes.

### 3 - Bankruptcy Exception

If you get debt discharged as part of a Bankruptcy, you do not owe taxes on that debt.

### Claw Back

In each of these three exceptions, the IRS wants to be paid back for the amount of the "discharge of indebtedness" (the amount that you didn't have to pay taxes on). They call this "claw back". It means that the IRS requires you to look for a way to reduce your other tax deductions to make up for not paying taxes on the COD Income. Some examples of "claw back" would be reducing the [tax basis](#) on the property, reducing the [tax basis](#) on another property, taking away passive losses, or taking away other losses on your return. If none of these options are available, then the IRS may not be able to get any "claw back".

You can see more details in [IRS Publication 4681](#).

Hopefully this helps clear things up somewhat, but obviously the tax consequences of a short sale, foreclosure, deed in lieu of foreclosure, or even a loan modification are fairly complex. As always, make sure to consult your tax professional.

POSTED AT 5:41 AM 

---

6 COMMENTS:

 Greg said...

There's a lot of good information here, but you're conflating the debt forgiveness and capital gains tax concepts a bit. Capital gains is the difference between what you bought and sold a property for--with the "sale" value in the case of an involuntary disposition being FMV. Debt forgiveness is the difference between FMV and the amount owed on a house at the time of disposition (to a bank or third party in a short