

The Tax Implications of Foreclosures

GOING THROUGH A FORECLOSURE on your principal residence is stressful enough, but there are tax implications too. While some are fairly harmless, others can be pretty bad.

Here's what you need to know:

Foreclosure Tax Basics

A foreclosure transaction occurs when a mortgage lender repossesses a borrower's property and then sells it to pay off the debt. In most cases, however, a foreclosure will only happen when the mortgage debt exceeds the property's fair market value, or FMV. In this situation, the federal income tax rules treat the foreclosure as a sale for the FMV amount.

Therefore, a tax gain will result if the property's FMV exceeds its tax basis. (The tax basis of a principal residence usually equals the original cost of the property, plus the cost of any improvements.) On the other hand, a tax loss will result if the property's FMV is less than the tax basis.

If a mortgage lender also forgives some or all of the debt against your property in conjunction with or after the foreclosure transaction, you have cancellation of debt (COD) income. That income is taxable unless an exception applies.

Remember: Just because your property is foreclosed doesn't necessarily mean the lender will forgive any of the unpaid mortgage balance (the so-called deficiency). When there is no forgiveness, there is no COD income. That said, mortgage lenders in these tough economic times sometimes will forgive all or part of the deficiency, so COD income can be fairly common these days.

Don't Forget the Home Sale Gain Exclusion Break

Another thing to consider is whether or not you qualify for the federal home sale gain exclusion break, which allows an unmarried person to exclude (pay no tax on) a gain of up to \$250,000 while married joint filers can exclude up to a \$500,000 gain. To qualify, you generally must have: (1) owned the home for at least two years during the five-year period ending on the foreclosure date and (2) used the home as your principal residence for at least two years during the five-year period ending on that date.

Here are some examples of foreclosed principal residence scenarios to illustrate how the tax rules work.

Foreclosure With Tax Gain

Example: Say your home is foreclosed when its FMV is \$325,000 and its tax basis is \$275,000. There's a \$250,000 first mortgage and a second of \$180,000. So the total debt equals \$430,000.

Assume the entire \$250,000 first mortgage and \$75,000 of the second get paid off when the lenders sell the property. That leaves an unpaid balance of \$105,000 (\$430,000 - \$325,000). You scrape together \$25,000 to pay the balance down to \$80,000, and the second mortgage lender forgives the rest.

Here are the tax results:

* The foreclosure triggers a \$50,000 tax gain (\$325,000 FMV - \$275,000 basis = \$50,000 gain). For federal income tax purposes, you can probably exclude (pay no tax on) the gain thanks to the home sale gain exclusion break. (State income tax results may vary.)

* The \$80,000 forgiven by the second mortgage lender is COD income. It's taxable unless an exception applies. See my earlier *article*¹ for the exceptions that may apply to this situation.

Foreclosure With Tax Loss

It's also quite possible to have a principal residence foreclosure where the FMV of the property is less than its tax basis. In that case, you'll have a tax loss instead of a gain.

Example: Say the FMV of your principal residence is \$300,000 when it's foreclosed, and the property's tax basis is \$390,000. There's a \$250,000 first mortgage and a second of \$175,000, for total debt of \$425,000.

The full \$250,000 first mortgage and \$50,000 of the second get paid off when the lenders sell the property. That leaves an unpaid balance of \$125,000 (\$425,000 - \$300,000). You scrape up enough to pay the balance down to \$60,000, and the second mortgage lender forgives the rest.

The tax results are as follows.

* The foreclosure triggers a \$90,000 tax loss (\$300,000 FMV - \$390,000 basis = \$90,000 loss). Unfortunately, the loss is considered a nondeductible personal expense for federal income tax purposes (and usually for state income tax purposes, too).

* The \$60,000 forgiven by the second mortgage lender is COD income. It's taxable unless an exception applies. Once again, see my earlier *article*² for the exceptions mostly likely to be available.

The Bottom Line

Probably the most important thing to understand about a principal residence foreclosure is that the mortgage lender will not necessarily forgive any of the unpaid balance that remains after the property is sold. However, in the current environment, some forgiveness would not be unusual. Also, keep in mind that you may not know for quite a while after the foreclosure whether anything will be forgiven.

Tax-wise, the most important thing to understand is that a foreclosure can potentially result in a taxable gain, and it might result in some taxable COD income, too.

Fortunately, with a principal residence foreclosure, an otherwise-taxable gain can often be excluded for federal purposes thanks to the home sale gain exclusion break (state income tax results can vary). Also, some or all of the COD income may be tax-free thanks to favorable tax-law exceptions. However when no exception applies, the COD income is fully taxable.

¹<http://www.smartmoney.com/personal-finance/taxes/the-tax-implications-of-debt-forgiveness/>

²<http://www.smartmoney.com/personal-finance/taxes/the-tax-implications-of-debt-forgiveness/>

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