

FORECLOSURES AND SHORT SALES – CONSIDER THE TAX IMPLICATIONS

(For complete and up-to-date information regarding tax liability, please consult with your CPA or financial advisor)

With residential foreclosures and defaults on the rise (Note: according to the *Franchise Tax Board* “only two states exceed California in rate of foreclosures: Nevada and Colorado”) many Californians are inclined to just walk away from their mortgages. However, before “giving the keys back to the bank,” it is wise to consider the tax consequences of such actions.

Generally, in a non-judicial foreclosure, the lender exercises its security interest (pursuant rights under the deed of trust) in the property and disposes of the same at a public sale. If the sale price is less than the remaining indebtedness, depending on a variety of factors, the lender may or may not hold the borrower personally liable for the deficiency. In a short sale, the borrower sells the property to a third party for a price that is less than the present indebtedness. The lender may cancel the balance of the debt (i.e. present indebtedness – sale price).

In order to determine the tax consequences of the transaction, one must first determine whether the indebtedness is “recourse” or “non-recourse.” Briefly, when the debt is considered “recourse,” the lender may be able to hold the borrower personally responsible for the deficiency when the foreclosure sale price is less than the indebtedness (Note: California’s “One Action Rule” (C.C.P. §580d) might bar a subsequent action for deficiency). Conversely, a non-recourse debt is an obligation where the lender’s recovery is limited to the pledged collateral.

Generally, under C.C.P. §580b, certain loans are deemed to be “non-recourse” by statute. The following elements must be present: (1) the loan is secured by real property, (2) the real property must be a “dwelling for not more than four families,” (3) the loan “was in fact used to pay all or part of the purchase price of that dwelling,” and (4) the dwelling is “occupied, entirely or in part, by the purchaser.” More likely than not, under a “standard” loan where proceeds are used to acquire an owner-occupied dwelling, the loan is considered non-recourse. Furthermore, any waiver in the initial loan document itself is generally unenforceable. Nevertheless, when such loans are refinanced, they ordinarily lose their “non-recourse” status (although a review of the facts and circumstances needs to be made in order to determine whether this has, in fact, taken place). Accordingly, many borrowers have inadvertently waived the protection of 580b through conduct (i.e. refinancing).

As for the tax consequence, when a lender discharges any part of a debt, the taxpayer generally recognizes that amount as ordinary income. This encapsulates the *basic* rule. When a non-recourse debt is canceled in exchange for the property, the transfer is treated as a sale of the property. The difference between the outstanding debt and the homeowner’s adjusted tax basis (ordinarily, the acquisition price) in the house is

considered a gain or loss on the sale of the home. IRC § 121 should be reviewed in order to determine whether any gain realized would have to be recognized (i.e. included on tax returns and taxable).

Where the debt is recourse, the transaction is split into two parts: (1) A taxable disposition of the property; and (2) to the extent the fair market value of the residence is less than the unpaid debt, either a continuing debt obligation is owed to the lender or the remainder of the debt is discharged. Forms 1099-A or 1099-C are issued by lenders to report the income tax consequences of a foreclosure, short sale, abandonment or deed in lieu of foreclosure.

If the lender issues Form 1099-C, the taxpayer should check to see whether (1) s/he was personally liable for the obligation (box 5), and (2) box 2 (“Balance of principal outstanding”) is greater than box 4 (“Fair market value of the property”). If these requirements are met, the taxpayer could have cancellation of debt income. However, the Mortgage Forgiveness Debt Relief Act of 2007 (IRC Sec. 108(a)(1)(E)) allows homeowners to exclude from income “qualified principal residence indebtedness” cancelled between 2007 and 2012. The taxpayers can exclude up to \$2 million (\$1 million for married filing separate) of cancellation of debt. The exclusion applies only to “acquisition indebtedness” (i.e. any indebtedness incurred in acquiring, constructing or substantially improving) secured by the taxpayer’s residence. To the extent that the refinance loan is used to substantially improve the residence, that portion also qualifies as “acquisition indebtedness.” Form 982 must be attached to the taxpayer’s tax return in order to report. Taxpayers should consult with their tax adviser/CPA for the proper completion and filing of this form along with the tax return.

For California tax purposes, SB 1055 (Sept. 25) provides limited relief for discharges occurring prior to January 1, 2009 (e.g. limits debt relief to \$250,000 for taxpayers who file as married/registered domestic partner filing jointly, single, head of household, or widow/widower, and to \$125,000 for taxpayers who file as married/registered domestic partner filing separately).

A more confusing question is presented when the lender issues Form 1099-A. Technically, when this form is issued, the lender has not taken the categorical position that any debt is being discharged. Furthermore, in California, this is a hint to the taxpayer that, usually pursuant to a refinance (but also a home equity loan), the lender is regarding all or part of the loan as “recourse.” Taxpayers should consider contacting the lender to determine whether (i) the lender is taking the position that the loan is recourse and (ii) a Form 1099-C will be issued. In addition, taxpayers are advised to contact their CPA, tax professional and/or preparer in order to consider the filing of Form 982 in conjunction with the receipt of Form 1099-A and, in the future, once more in conjunction with the receipt, if any, of Form 1099-C.