

Tax Consequences for Foreclosure or Short Sale of Rental, Investment and Second Home Properties

Foreclosures are treated as the sale of property for tax purposes. Homeowners going through a foreclosure will need to calculate their gain or loss for tax purposes, as well as consider any tax that might be due on the forgiveness or cancellation of debt.

Determining the Selling Price

The basic formula for capital gains is to subtract the [basis or cost of the property](#) from the selling price. In a foreclosure situation, the selling price used for tax purposes depends on whether the loan was a recourse or a non-recourse loan.

A recourse loan is a loan where the borrower is personally liable for the debt, and the lender can pursue repayment even after the property has been repossessed.

A non-recourse loan is a loan where the borrower is not personally liable for repayment of the loan; in other words, once the lender repossesses the property used to secure the loan, the loan is satisfied and the lender cannot pursue the borrower for further repayment.

According to our banking and loans expert Justin Pritchard, mortgages used to acquire a house tend to be non-recourse loans, while refinanced loans and home equity loans tend to be recourse loans. How these loans are classified depends on state lending laws. For more information, see [Recourse Loans and Non-Recourse Loans](#).

Determining Gain or Loss on a Foreclosure

For recourse loans, the figure used as the selling price is the lower of the following two amounts:

- the outstanding loan balance immediately before the foreclosure minus any debt for which the borrower remains personally liable after the foreclosure; or
- the fair market value of the property being foreclosed.

For non-recourse loans, the figure used as the selling price is the outstanding loan balance immediately before the foreclosure. You are considered as selling the house to the lender for full consideration of the outstanding debt.

Canceled Debt Issues

Foreclosures can trigger taxable income besides capital gains. If the lender forgives or cancels the mortgage debt, it may need to be included as income unless an exception applies.

For recourse loans, the amount of debt canceled by the lender is potentially taxable income. There are a number of exceptions that exclude [canceled debts](#) from tax treatment. The most important of these is the exclusion for debt secured by your main home. Under the [Mortgage Forgiveness Debt Relief Act](#), canceled debts of up to \$2 million can be excluded as long as the debt was used to buy or build your principal residence. [The Emergency Economic Stabilization Act](#) extends this debt relief through 2012.

For non-recourse loans, there is no cancellation of debt income to be reported. That's because the lender cannot pursue the borrower for repayment of the debt, even if the fair market value of the property is less than what was owed.

Tax Consequences for a Main Home

A main home is real estate used as the primary residence of the taxpayer. If a main home is foreclosed, the individual has available several exclusions to shield himself from taxes. First, any [capital gains on a main home can be excluded](#), up to \$500,000 for married couples or \$250,000 for unmarried persons.

Second, if the mortgage loan was a non-recourse loan, the borrower would have no canceled debt income to report.

Third, if the mortgage loan was a recourse loan, the borrower can take exclude up to \$2 million of canceled debts if the loan proceeds were used to buy or build a primary residence. Home equity loans can potentially be excluded from tax as well using the [exclusion for insolvency](#).

Tax Consequences for Property Other than a Main Home

Second homes, vacation property, and rental properties can be foreclosed. Capital gains and canceled debt income are calculated in the same way. However, these properties do not qualify for the \$2 million exclusion, nor do they qualify for the \$250,000 capital gains exclusion; these two exclusions apply only to a main home.

Still, borrowers can shield themselves from taxes by using the various [exclusions for canceled debts](#). In particular, it is likely that taxpayers will qualify for the [insolvency exclusion](#).

Owners of rental property will want to take note of the [depreciation recapture tax](#). This is a special type of capital gains tax based on the amount of depreciation deducted against the rental income.

Rental versus Investment Property

In the case of a rental property, it's not as bad as you may think it is. In the case of an investment property, though, it could be devastating. Here are some examples.

Let's say you buy a property for \$400,000 and hold it, waiting for the value to go up. In this case, you have an investment property. Let's assume you have a loan of \$360,000 on the property. And you end selling it through a short sale for \$250,000. The lender forgives the extra debt of \$110,000 (\$360,000 - \$250,000). And he then gives you a 1099-C that shows \$110,000 of debt forgiveness, in other words, income. In this case, you also have a loss. Your basis in the property was \$400,000 and you just sold it for \$250,000. That means you have a loss on the property of \$150,000 (\$400,000 - \$250,000).

Now here is where it gets dicey. Because it's an investment property, you have a CAPITAL loss on the property. That means you can take the capital loss against your capital income and then take an additional \$3,000. If your loss is \$150,000, you have 50 years of \$3,000 per year of loss ahead of you.

But let's say you put the property in service first, now you have a rental property. That means any gain or loss you have on the disposal is an ORDINARY gain or loss.

Let's use the same numbers: \$400,000 with a loan of \$360,000. You get a short sale of \$250,000. You still have an income issue of \$110,000 from the debt forgiveness. But you also have a loss of \$150,000. In this case, though, you have an ordinary loss on the property. That means it works against other income, not just capital income. In you have an investment property, turn it into a rental property before you sell it at a loss.

You can contact us with any questions you may have about your specific situation.