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I Received a 1099 from My Lender, Now What?

Tax Consequences of Foreclosure or Short Sale of Personal Residence in Arizona

By: Beth S. Cohn

It is difficult to read any economic news or watch a local TV news program without seeing the prevalence of foreclosures and short sales of personal residences in Arizona. It is not uncommon in today's economic crisis to own a home that was purchased in the last five years that is substantially "upside down". Many neighborhoods have more than one of these properties, driving down the value of other houses in the neighborhood. Some people have given up and don't want to keep paying mortgage payments on houses on which their mortgage is double what the house may be worth. Others simply cannot keep making the payments due to an interest rate reset, hardship, or job loss. The step to attempt a short sale or allow the bank to complete a foreclosure sale is difficult. Either one may result in tax consequences to the homeowner.

What is the Difference Between a Short Sale and a Foreclosure?

A short sale is when a homeowner has certain financial or personal hardships and enters an agreement with the lender to sell their house for less than the amount of the outstanding mortgage on the home. The balance of the obligation is forgiven by the lender when the property is sold. The difference between a short sale and a foreclosure is that in a short sale, the residence does not go through a formal sale that is controlled by Arizona statutes, commonly called either a foreclosure or a "Trustee's Sale".

In a foreclosure, the lender, uses of a third party "Trustee" who gives a 90 day notice that the property is going to be sold. Until 5:00 p.m. of the day before the Trustee's Sale, the homeowner can reinstate the loan by paying all prior payments, plus all costs of the sale, including the Trustee's and their attorney's fees. If the property goes to sale, the lender in many cases may make the initial bid. If the house is sold at the Trustee's Sale, for less than the amount of the outstanding debt, the buyer could be the lender or a third party. Under Arizona law, if the loan is considered a "purchase money" loan, the house is on 2 ½ acres or less **and** is a single one family or two family dwelling, the lender cannot go after a deficiency (the shortfall between the outstanding debt and the sales price) against the homeowner. A purchase money loan is defined as using the proceeds of the loan to purchase the residence. In Arizona, this is what is frequently referred to as the "anti-deficiency" rules.

With the anti-deficiency rules, the homeowner walks away and does not owe the lender any balance after the Trustee's Sale. The anti-deficiency rules **do not** apply to home equity credit lines where the money was not used to purchase the residence. Other questions may arise if the existing loan is a refinance of an original purchase money loan. These issues are not being discussed in this article. They are complicated and need separate review and analysis by an attorney.

How Do Short Sales or Foreclosure Impact How Much Tax is Due?

In 2007, Congress passed the Mortgage Forgiveness Debt Relief Act (the "Act"). The Act provides that homeowners can exclude from income the discharge of "qualified principal residence indebtedness" on the foreclosure or restructure of such debt on a personal residence of up to $2 million (if married) or $1 million (if married filing separately). A single person is not directly addressed by the law. To determine whether the Act applies on a foreclosure or a short sale of a personal residence in Arizona, we have to examine if the homeowner has personal liability for any portion of the debt when the transaction is completed. In Arizona, if the loan on the house is considered a purchase money loan and the homeowner does not have liability to pay the loan, both a short sale and a foreclosure are **not considered** "discharge of debt" for income tax purposes under the Act. In both cases, the homeowner is treated as having sold the residence.

The following illustrations will help explain the tax consequences of a short sale or a foreclosure of a personal residence in Arizona. The assumptions are that the property is the owner's primary residence, the loan is a purchase money loan and the Arizona anti-deficiency rules apply.

Example 1

Purchase price was $300,000; balance of loan is $300,000 and Short sale for $200,000

The sales price to a third party is $200,000 and the lender forgives the balance of $100,000:

Result: Sales price is $300,000 and gain on sale is $0. There is no gain on the sale of the residence and no debt discharge income. There would be no tax consequence.

Purchase price was $300,000; balance of loan is $300,000 and Trustee Sale Bid for $300,000

Trustee's Sale and lender and/or third party bids $300,000: There is no balance to forgive.

Result: Sales price is $300,000 and gain on sale is $0. There is no gain on the sale of the residence and no debt discharge income. There would be no tax consequence. The same result as the short sale.

Example 2

Purchase price was $400,000; balance of loan is $300,000 and Short Sale for $200,000

The sales price to the third party is $200,000 and the lender forgives the balance of $200,000.

Result: Sales price on the house is $300,000 and the homeowner has a non-deductible capital loss of $100,000. Losses on personal assets cannot be deducted.

Purchase price was $400,000; balance of loan is $300,000 and Trustee's Sale for $200,000

Trustee's Sale and a third party successfully bids $200,000:

Result: Sales price is $300,000 and the homeowner has a non-deductible capital loss of $100,000. Losses on personal assets cannot be deducted. This is the same result as a short sale.

In these examples, either a short sale or a foreclosure is treated as a sale of the property for the amount of the debt for tax purposes. A short sale may be a better option for tax purposes if the loan is not a purchase money loan or there is a home equity credit line. The tax consequences of a short sale or a foreclosure for these types of loans where the Arizona anti-deficiency statutes or the Act do not apply are not addressed in this article.

Reporting Requirements

Whether a specific loan is discharged on the lender's books by a short sale or a Trustee's Sale, the lender is required by the IRS to issue a 1099-C for the forgiven portion of the loan to the borrower. There is a box that the lender checks on the 1099-C that indicates whether the borrower is personally liable or not personally liable for the loan. On a purchase money loan for a personal residence in Arizona, the lender should check the box that states that the borrower is **not personally liable** because of the Arizona anti-deficiency statutes. In this case, the IRS should not be looking to match the 1099-C with the taxpayer reporting income from forgiveness of indebtedness.

Any sale of a personal residence should be reported on Schedule D of IRS Form 1040 if any portion of the gain on the sale is not excluded under IRC § 121.

If the lender should make an error on the 1099-C, showing that the borrower was personally liable, the borrower should contact the lender and request that a corrected 1099-C be filed. IRS Form 982 is used for discharge of qualified principal residence indebtedness.

Conclusion

These issues are complex and each loan and each situation is different. They will require analysis by a qualified CPA or attorney. The rules for loans that do not qualify for the anti-deficiency statutes are much different and will result in reportable income from the discharge of debt. Do not automatically assume that the amount of a loan that is discharged on a personal residence is not included as taxable income.

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