Law Offices
James J. Falcone
300 Capitol Mall, Suite 1800
Sacramento, California 95814-4717

916/442-4204

February 16, 2010

What are the Tax Consequences of Residential Foreclosures and Short Sales?

While tax consequences may be the last thing on the mind of homeowners facing a real estate foreclosure, they play a role in the bigger picture and should be part of the decision process. What follows is a simple discussion of three aspects of personal income tax factors that should be considered.

1. **Cancellation of Debt Income**: when a debt is wiped out and you are no longer liable for it, it can be considered income, which is reported by the lender on form 1099-C. It is taxable unless either:

A. You are subject to the Mortgage Debt Forgiveness Act, which applies if the debt was forgiven in years 2007 through 2012. This requires that the debt was incurred to buy or substantially improve the taxpayer's principal residence. This includes a refinance loan, to the extent that the principal balance of the old mortgage would have qualified;

B. The debt was discharged in bankruptcy;

C. The taxpayer is insolvent, some or all of the cancelled debt may not be taxable (requires a special filing with the IRS);

D. The mortgage debt was **non-recourse**; or

E. Certain farm debts.

2. **Short Sales**: follow the same rules as foreclosures;

A. If the lender cancels the deficiency balance (the amount of the loan over what the buyer paid), the taxpayer can have cancellation of debt income, subject to the exclusions above;

B. If the loan was **non-recourse**, or the lender requires the taxpayer to sign a new note, becoming personally liable for the debt, there is no cancelled debt.

3. **Capital Gains**: foreclosures and short sales are treated as sales. The fair market value ("FMV") is compared with the adjusted basis of the property (purchase price plus cost of major improvements). If the FMV is higher than adjusted basis, there is a capital gain.

This gain can be excluded (not taxed) if the property was the taxpayer's principal residence for a total of two years during the five years prior to the foreclosure; if so, you can exclude $250,000, or if you are a married couple filing jointly, $500,000.

Disclaimer
The content of this comment contains general information and is provided for informational purposes only, and should not be construed as legal or tax advice on any subject matter. You require specific legal and tax advice and should not rely on general information provided here. You should consult with an attorney or C.P.A. to discuss the matter and for any specific legal or tax advice.

Law Office of James J. Falcone
JFalconeLaw.com