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Tax Impact of Short Sales and Foreclosures of Investment Property

A few months ago I was asked what would be the tax effect of selling an investment property in a "short sale" or having it foreclosed upon. Although I have been involved with tax deferred exchanges for nearly a decade, until recently this was not an issue that came up on a regular basis. The answer is complicated and depends upon many factors including the applicable state law, the type of investment property and the rights of the lender under loan. For the purposes of this article, we will discuss the impact based upon existing laws in the State of Arizona.

Short Sales

In a short sale, the lender agrees to accept less than the balance owed by the borrower and also agrees to release the property from its lien; thereby permitting it to be sold "free and clear" of the prior loan. This creates debt relief called cancellation of debt income (COD). Since only primary residences are covered by the Mortgage Forgiveness Act of 2007, the short sale of an investment property creates taxable income to the owner in the amount of debt being forgiven. For more information about the Mortgage Forgiveness Act of 2007 see Publication 4705 (available at www.irs.gov). Cancellation of Debt Income is taxed at ordinary income tax rates (which can be considerably higher than capital gain tax rates). In addition, if the sale price in the short sale is greater than the tax basis of the property, the owner will also be required to pay capital gain taxes. This will be calculated by subtracting the tax basis from the sale price. In summary, the investor who sells an investment property in a short sale (regardless of what type of investment property it is) will be potentially liable for two separate taxes; ordinary income tax on the debt relief (COD) and capital gain tax on the capital gain even though he or she did not receive any money at closing!

To illustrate, let's assume Ivan Investor sells a residential rental, with a loan balance of $220,000 in a short sale for $200,000. Let's also assume Ivan's tax basis in the property is $100,000. Ivan will have cancellation of debt income of $20,000 and capital gain of $100,000. He will pay ordinary income taxes on $20,000 and capital gain taxes on $100,000 (plus depreciation recapture tax).

Foreclosures

Losing an investment property in a foreclosure is more complicated because it depends on whether it is encumbered by a recourse or non-recourse loan. A loan is "recourse" if the borrower is personally liable for the entire amount due even after the property has been foreclosed. If the loan is "recourse" the lender can pursue the borrower for any deficiency (after foreclosure) including obtaining a judgment against him or her. Conversely, a loan is "nonrecourse" if the lender cannot pursue a deficiency against the borrower; its only remedy is to repossess the property. Arizona law (A.R.S. 33-814) provides that if the property subject to a Deed of Trust is located on two and one-half acres or less and utilized as a single family residence or two family residences, then the lender cannot pursue a deficiency judgment. Accordingly, loans on single family residences and duplexes situated on 2.5 acres of land or less are non-recourse in Arizona (except for VA loans).

The Internal Revenue Code treats foreclosures like sales for tax purposes; accordingly, capital gain taxes may be due. The “sale price” is the fair market value of the property immediately prior to foreclosure (if it is a recourse loan) and the amount of the debt immediately prior to the foreclosure (if it is a non-recourse loan). Accordingly, if the investment property is a single family residence or a duplex, the owner who loses it to foreclosure will have the potential of capital gain income but not cancellation of debt income. They will pay capital gain tax on the difference between the total amount of the debt and their tax basis. However, if the loan on the

investment property is recourse (the property is anything but a single family rental or a duplex) the owner might also be subject to cancellation of debt income (difference between the total amount of debt and the fair market value of the property and capital gain (difference between the fair market value of the property and its tax basis).

Let’s assume Ivan’s investment property was foreclosed instead of being sold in a short sale. We will again assume it has a total loan balance of $220,000, a fair market value of $200,000 and a tax basis of $100,000.

If Ivan’s property is a single family rental or duplex, he would not have any cancellation of debt income but would have a capital gain of $120,000 (difference between the debt and the basis). However, if it was any other type of investment property (vacant land, a triplex, a commercial building, etc.), Ivan would have $20,000 of cancellation of debt income and $100,000 capital gain. Although in both situations, he has $120,000 of income, he would probably pay more taxes where he had cancellation of debt income since ordinary income rates can be up to 20% higher than capital gain taxes.

As you can see there are a lot of variables which can impact the taxes which will be paid if an investment property is sold in a short sale or is foreclosed. Accordingly, it is very important for investors to review their specific situation with a tax professional and find out what the impact will be before a short sale or foreclosure.