Foreclose on a House, - Don’t Forget Your Taxes!

Yes, taxes but no house. If losing your house is bad enough, owing Uncle Sam money puts salt in the open wounds. There is the possibility that you could realize capital gain on a foreclosure. Be sure to check out IRS Pub. 544 for more details. If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which you may realize gain or loss. You figure and report gain or loss from a foreclosure or repossession in the same way as a gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized.

This is true even if you voluntarily return the property to the lender. You also may realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

Buyer’s (borrower’s) gain or loss: You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized. See the section on Gain or Loss from Sales and Exchanges in IRS Pub. 544. http://www.irs.gov

Here is an example:

Anna paid $200,000 for her home. She paid $15,000 down and borrowed the remaining $185,000 from a bank. Anna is not personally liable for the loan (nonrecourse debt), but pledges the house as security. The bank foreclosed on the loan because Anna stopped making payments. When the bank foreclosed on the loan, the balance due was $180,000, the fair market value of the house was $170,000, and Anna’s adjusted basis was $175,000 due to a casualty loss she had deducted.

The amount Anna realized on the foreclosure is $180,000, the debt canceled by the foreclosure. She figures her gain or loss by comparing the amount realized ($180,000) with her adjusted basis ($175,000). She has a $5,000 realized gain.

Amount realized on a recourse debt: When you are personally liable for the debt also known as recourse debt, the amount realized on the foreclosure or repossession does not include the canceled debt that is your income from cancellation of debt. If the fair market value of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the fair market value of the property. You are treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the fair market value. See Cancellation of debt, later.

Assume the same facts as in the Example, except Anna is personally liable for the loan (recourse debt). In this case, the amount she realizes is $170,000. This is the canceled debt ($180,000) up to the fair market value of the house ($170,000). Anna figures her gain or loss on the foreclosure by comparing the amount realized ($170,000) with her adjusted basis ($175,000).

She has a $5,000 nondeductible loss. She is treated as receiving ordinary income from cancellation of debt. (The debt is not exempt from tax as discussed under Cancellation of debt, below.) That income is $10,000 ($180,000 - $170,000). This is the part of the canceled debt not included in the amount realized.

The IRS provides a worksheet to aid you in figuring out Table 1-2. Worksheet for Foreclosures and Repossessions

Visit the Getting Through Tough Financial Times website at http://www.ToughTimes.illinois.edu
Part 1. Figure your income from cancellation of debt. (Note: If you are not personally liable for the debt, you do not have income from cancellation of debt. Skip Part 1 and go to Part 2.)

1. Enter the amount of debt canceled by the transfer of property.
2. Enter the fair market value of the transferred property.
3. Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero.

Part 2. Figure your gain or loss from foreclosure or repossession.

4. Enter the smaller of line 1 or line 2. Also include any proceeds you received from the foreclosure sale. (If you are not personally liable for the debt, enter the amount of debt canceled by the transfer of property.)
5. Enter the adjusted basis of the transferred property.
6. Gain or loss from foreclosure or repossession. Subtract line 5 from line 4.

The income may not be taxable. See Cancellation of debt.

Cancellation of debt: If property that is repossessed or foreclosed on secures a debt for which you are personally liable (recourse debt), you generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession. Report the income from cancellation of a debt related to a business or rental activity as business or rental income. Individuals, report the income from cancellation of a non-business debt as other income on Form 1040, line 21. Partnerships, corporations, and other entities, report the income on the comparable line on your tax return.

Seller’s/lender’s gain or loss on repossession: If you finance a buyer’s purchase of property and later acquire an interest in it through foreclosure or repossession, you may have a gain or loss on the acquisition. For more information and a worksheet to use, see IRS Repossession in Publication 537. www.irs.gov

Source: IRS.gov