Q. 8052**. What is the tax treatment of nonrecourse debt discharged pursuant to a foreclosure, short sale or deed in lieu of foreclosure?**

All of the ensuing income is treated as gain from the sale of the underlying property included in gross income under IRC Section 61(a)(3) (rather than IRC Section 61(a)(12). This means that none of the exceptions with respect to discharge of debt income can apply. Such result illustrates the difference between recourse and nonrecourse debt. With respect to recourse debt, in the event that the fair market value of the secured property is less than the outstanding debt, there is no inherent forgiveness of the shortfall. In other words, after the foreclosure, short sale or deed in lieu of foreclosure, the creditor has the option to legally pursue collection of the deficiency. If the creditor chooses not to do so and forgives the shortfall for no additional consideration, the forgiven amount is discharge of debt income. On the other hand, with respect to nonrecourse debt, the debtor has no personal liability beyond the secured property. So, upon the transfer of the property to the lender or third party (short sale), the deficiency (the difference between the fair market value of the property and the outstanding balance) is eliminated without any further action by the creditor.

*Example*: In 2012, Asher purchased a commercial building totally funded from the proceeds of a $100,000 nonrecourse loan secured by the building. Several years later when the principal amount of loan was still $100,000, Asher defaulted on the loan and the lender foreclosed on the property. At that time, fair market value of the building was $80,000 and the adjusted basis of the building was $60,000 (original basis reduced by $40,000 of depreciation deductions).

Because the debt is recourse, Asher is deemed to have sold the property to the lender for the outstanding balance of the loan ($100,000) even though the fair market value of the property was only $80,000. In other words, if the loan had been recourse, the transfer of the property to the lender would be treated as a partial payment of a $100,000 loan. The balance would remain owing unless the lender choose to forgive it. Because the loan is nonrecourse, however, the entire debt is deemed satisfied by the transfer of property, resulting in a $60,000 gain included in gross income pursuant to IRC Section 61(a)(3) ($100,000 minus $40,000).

**Q. 8053. Is it better that the underlying debt associated with a foreclosure, short sale or deed in lieu of foreclosure be recourse rather than nonrecourse debt?**

The answer depends on the circumstances. If none of the exceptions to the inclusion of discharge of debt in gross income apply (see Q9), then it is better that the debt be nonrecourse. This is because the character of discharge of debt income is ordinary (potentially subject to the highest income tax rates) whereas the character of the income from the transfer of property subject to nonrecourse debt is capital gain (subject to the more preferential capital gain rates).

Conversely, if the exceptions due apply (see Q 8056), then it is better that the debt be recourse. This because the amount of discharge of debt income may be totally or partially excluded from gross income. As to the income generated from the transfer of property subject to nonrecourse debt (capital gain) none of the exceptions apply. Therefore, none of that income would be excluded from gross income.