**Q. 8049. What is the tax treatment of recourse debt discharged pursuant to a foreclosure, short sale or deed in lieu of foreclosure?**

Foreclosures, short sales and a deed in lieu of foreclosure are treated as sales of the underlying property for tax purposes.[[1]](#endnote-1) In any of those circumstances, the debtor transfers the secured property to the lender or a third party (short sale).

**FAIR MARKET VALUE OF UNDERLYING PROPERTY IS EQUAL OR GREATER THAN THE OUTSTANDING DEBT.**

If the fair market value of the underlying property is equal or greater than the amount of the outstanding recourse debt, none of the resulting income would be treated as discharge of debt income.

*Example*: In 2012, Asher purchased a commercial building totally funded from the proceeds of a $100,000 recourse 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, the fair market value of the building was $100,000 and the adjusted basis of the building was $60,000 (original basis reduced by $40,000 of depreciation deductions). Because the fair market value of the property was equal to the outstanding balance of the loan, it is as if Asher sold the building to the lender for $100,000 which he used to repay the loan. Since the basis of the building was $60,000, Asher has a $40,000 gain included in gross income under IRC Section 61(a)(3) ($100,000 minus $60,000). Thus, there is no discharge of debt income.

**FAIR MARKET VALUE OF UNDERLYING PROPERTY IS LESS THAN THE OUTSTANDING DEBT.**

On the other hand, if the fair market value of the underlying property is less than the outstanding recourse debt, after giving the debtor credit for the fair market value of the secured property, a foreclosing lender has two options. The first option is to pursue a legal collection action against the debtor to satisfy the shortfall. The second option is to simply forgive the shortfall. In both cases, the debtor is deemed to have sold the underlying property to the lender for the fair market value of the property which he or she in turn uses to make a partial payment on the outstanding balance of the loan. In the latter case, the amount of the forgiven debt (the difference between the outstanding balance of debt less the fair market value of the property) would be considered discharge of debt income.

*Example*: In 2012, Asher purchased a commercial building totally funded from the proceeds of a $100,000 recourse 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, the 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). After crediting the fair market value of the property against the outstanding balance of the loan, the lender chooses to forgive the $20,000 shortfall for no consideration. Because the fair market value of the property was only $80,000, it is as if Asher sold the building to the lender for $80,000 which he turn used as a partial repayment of the loan. Since the basis of the building was $60,000, Asher has a $20,000 gain included in gross income under IRC Section 61(a)(3) ($80,000 minus $60,000). The $20,000 remaining balance written off by the creditor would be considered discharge of debt income under IRC Section 61(a)(12).

**Q. 8050. Is it possible to have a taxable loss and discharge of debt income as a result of a foreclosure, short sale or deed in lieu of foreclosure?**

Yes. Although it may seem incomprehensible as to how a transaction that generates a tax loss can also trigger discharge of debt income, it is possible.

*Example*: In 2012, Asher purchased a commercial building totally funded from the proceeds of a $100,000 recourse 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 $90,000 (original basis reduced by $10,000 of depreciation deductions). After crediting the fair market value of the property against the outstanding balance of the loan, the lender chooses to forgive the $20,000 shortfall for no consideration. Because the fair market value of the property was only $80,000, it is as if Asher sold the building to the lender for $80,000 which he turn used as a partial repayment of the loan. Since the basis of the building was $90,000, Asher has a $10,000 taxable loss pursuant to IRC Section 165 ($90,000 basis minus $80,000 basis). The $20,000 remaining balance written off by the creditor would be considered discharge of debt income under IRC Section 61(a)(12).

**Q. 8051. Is there any tax significance between the characterization of income as discharge of debt income under IRC Section 61(a)(12) rather than gain from the sale of property under IRC Section 61(a)(3)?**

IRC Section 108 provides a number of exceptions that render all or part of discharge of debt income otherwise includible under IRC Section 61(a)(12) as being non-taxable. None of those exceptions apply to gain included in gross income under IRC Section 61(a)(3). (see Q. 8056)

1. *Helvering v. Hammel*, 311 U.S. 504 (1941); *Freeland v. Commissioner*, 74 T.C. 970 (1980); Treas. Reg. § 1.1001-2(a). [↑](#endnote-ref-1)