**Q7. What is the tax treatment of nonrecourse debt discharged pursuant to a foreclosure, short sale or deed in lieu of foreclosure?**

The short answer to the question is that all three transactions are treated as sales or exchanges of the underlying secured property. Therefore, all the ensuing income is treated as capital gain included in gross income under IRC Section 61(a)(3) (rather than IRC Section 61(a)(12). This means that none of the discharge of debt exclusions from gross income (see Q10) apply.

Such result highlights 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, the lender has no legal obligation to forgive the shortfall. In other words, after the foreclosure, short sale or deed in lieu of foreclosure, the creditor may pursue a legal collection action against the debtor to satisfy 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. So, if one or more of the discharge of debt exclusions from income apply, the discharged credit may escape taxation.

On the other hand, with respect to nonrecourse debt, the debtor has no personal liability for repayment 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 outstanding balance and the fair market value of the property) is extinguished without any further action by the creditor. Therefore, there is no discharge of debt income.

***Example*:** In 2012, Asher purchased a commercial building totally funded with 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 nonrecourse, 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 (to the extent of the fair market value). The balance would remain owing unless the lender choose to forgive it. In the case of a nonrecourse loan, 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).

**Q7A. 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 discharge of debt exclusions could apply (see Q10), 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 one or more of the discharge of debt exclusions could apply (see Q10), then it is better that the debt be recourse because some or all of the discharge of debt income may be excluded from gross income. As to the income generated from the transfer of property subject to nonrecourse debt (capital gain), none of the discharge of debt exclusions apply. Therefore, none of that income would be excluded from gross income.