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Income Tax Consequences on Foreclosure of A Residence

-by Neil E. Harl

The high-profile spate of home mortgage foreclosures, attributable in part, at least, to subprime mortgage lending, raises once again the question of the income tax consequences of such an event for the home owner. The income tax treatment departs from the usual rules for taxation of debt because of the exclusion for sale or exchange of the principal residence and because losses are not deductible except for losses on business or investment property. The general rule

Under the general rule, on foreclosure of a mortgage on real property which secures recourse debt, the difference between the property’s fair market value and the income tax basis for the property is considered the amount realized and is ordinarily the amount recognized from disposition of the property. If the debt discharged exceeds the fair market value of the property, the difference between the fair market value and the indebtedness is discharge of indebtedness income. Absent clear and convincing proof to the contrary, the sale price of property at a foreclosure sale is presumed to be its fair market value. In a 1998 Tax Court case, Frazier v. Commissioner, the amount paid at foreclosure sale was held to be in excess of the property’s fair market value with the amount realized determined based on the fair market value.

In the event it is non-recourse debt, the full amount of the difference between the basis and the amount of the debt is the gain recognized and there is no discharge of indebtedness income. The tax consequences

In Frazier v. Commissioner, the foreclosure transaction, involving recourse debt, was bifurcated into a taxable transfer of property and a taxable discharge of indebtedness. The first step of the process produced a capital loss of $120,544, representing the difference between the fair market value of the property, $375,000, and the taxpayer’s adjusted income tax basis in the property, $495,544. In the second part of the bifurcated transaction, involving discharge of indebtedness, the taxpayers realized $210,943 of ordinary income from discharge of indebtedness (the difference between the fair market value of the property and the amount of debt discharged). Of course, if the property is a principal residence, losses, whether capital losses or ordinary losses, are not deductible except to the extent that the property is investment property or trade or business property.

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Moreover, if the transaction meets the requirements to be a sale or exchange of a principal residence,¹⁴ the gain from the so-called first step in the process should be eligible for exclusion up to $500,000 on a joint return, $250,000 on a separate return.¹⁵ That assumes, of course, that the taxpayer or taxpayers have used the property as their principal residence for two or more of the last five years.¹⁶ A bankruptcy estate succeeds to the exclusion with respect to property transferred to the bankruptcy estate.¹⁷

There is a possibility that a foreclosure sale might be an “unforeseen circumstance”¹⁸ in which case a portion of the gain might be excluded if the property was used as the principal residence for less than two years out of the last five years. With respect to the scope of unforeseen circumstance, the regulations state that a sale or exchange meets the test if the primary purpose is the occurrence of an event the taxpayer could not have reasonably anticipated before purchasing and occupying the residence.¹⁹ To date, the Internal Revenue Service has not ruled on the issue of foreclosure as to whether it meets the tests to be an “unforeseen circumstance.” Safe harbors are provided in the regulations for several types of sales and exchanges including, among others, involuntary conversions, natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence.²⁰

While the only relief from gain on foreclosure is for principal residences and the special exclusion available if the requirements are met,²¹ there is an elaborate system of relief for discharge of indebtedness income.²² Taxpayers in bankruptcy²³ (including Chapter 12 bankruptcy);²⁴ taxpayers who are insolvent but not in bankruptcy²⁵ (including exempt assets in determining solvency or insolvency);²⁶ taxpayers who are dealing with qualified farm indebtedness;²⁷ taxpayers, other than C companies holding qualified real property business indebtedness²⁸ (which does not include farm indebtedness)²⁹ and those able to utilize the purchase price adjustment for solvent debtors³⁰ are eligible for relief for discharge of indebtedness income.

In conclusion

The severity (and policy significance) of the current crisis involving home mortgage foreclosures suggests that additional relief for debtors is not out of the question. The most likely remedial action would be to reduce the tax burden for discharge of indebtedness income.

FOOTNOTES

² I.R.C. § 121(a).
³ E.g., Gevirtz v. Comm’r, 123 F.2d 707 (2d Cir. 1941).