Minnesota Homeownership Center

VLN VOLUNTEER LAWYERS NETWORK

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Housing Preservation Project
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Tax Issues: Foreclosure and Workouts

Homeowners should be cautioned about the tax consequences of forgiveness of any portion of a loan, including a loan that goes through foreclosure. **Generally, there are no tax consequences for the foreclosed homeowner as a result of a foreclosure sale.** However, certain workout plans, including reducing the principal amount of the debt or waiving the deficiency under a deed in lieu, generate cancellation of debt ("COD") income.

Taxability of Foreclosure

A foreclosure occurs when a borrower becomes delinquent, and the home is sold at a sheriff's sale to the highest bidder. In Minnesota, a homeowner typically has six months to remain in the home once it has been sold. If a lender forecloses on property, the owner of the property is treated as having sold the property once the foreclosure is completed and any redemption period available to the owner has expired. Since the property is treated as sold, the IRS views this as a potential "taxable event." If there was any debt forgiven as a result of the sale, that forgiven debt is typically treated as COD income. Generally, but not always, any tax owed on COD income generated from a foreclosure is forgiven because of the Mortgage Forgiveness Debt Relief Act of 2007.

Debt Relief from Mortgage Forgiveness

The Mortgage Forgiveness Debt Relief Act of 2007 allows taxpayers to exclude debt forgiven on their principal residence (some loan limits apply). Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, may qualify for this relief. The original debt must have been used to buy, build or substantially improve the homeowner's principal residence and must have been secured by that residence. Refinanced debt, up to the amount of the qualifying debt just before refinancing, is also eligible.[1] In rare circumstances, a homeowner may receive a tax Form 1099-C from their mortgage lender, indicating the homeowner may owe COD income. If a homeowner receives a Form 1099-C, please encourage them to speak with a tax professional.

Non-Foreclosure Workouts

The owner may also be treated as having sold the property in a variety of other workout scenarios. This means some workouts may be taxable. Potentially taxable workouts include the following:

[1] 26 U.S.C. 108(a); 26 U.S.C. 108(h); 26 U.S.C. 163(h)(3)(B)

- **Deeds in Lieu of Foreclosure:** A "deed in lieu of foreclosure" occurs when the lender accepts a voluntary return of the deed to the property as an alternative to foreclosure.
- **Short Sales:** A short sale occurs when the owner (with the consent of the lender) allows the property to be sold to a third party, even if the proceeds of the sale will not cover the amount due on the mortgage.
- **Cash for Keys:** A foreclosed homeowner or a renter in a building facing foreclosure can sometimes be offered "cash for keys" in order to vacate the premises without requiring the lender to exercise all its legal remedies. While it may seem strange, the cash amount received by the homeowner or the renter in this situation may represent taxable income to them depending on how the transaction is documented.

Note: *This Fact Sheet provides general information and is not meant to be legal advice. Consult a competent legal professional or tax adviser for advice specific to your situation.*

For additional information speak with a Housing Counselor in your area by contacting the Minnesota Homeownership Center today: 651-659-9336 or 866-462-6466 or visit www.hocmn.org