Income tax in cases of abandoned, foreclosed, and reprocessed properties

Abandoned Property

When you abandon property, you voluntarily and permanently give up possession with the intent to terminate your ownership. An abandonment represents a total loss of your investment or interest in the property. If the property is business or investment property you may have a deductible loss. And the loss may be an ordinary loss (as opposed to a capital loss) even if the property is a capital asset. The amount of the loss is the adjusted basis of the property at the time of abandonment. Abandonment of personal property, such as a home, is not a deductible loss for federal income tax purposes.

An abandonment may lead to the property subsequently being foreclosed on or repossessed. In this case, the gain or loss would be determined according to the rules for foreclosures and repossessions.

Cancellation of Debt

If there is a debt that secures the property, such as a mortgage loan, and as a result of abandoning the property, that debt is cancelled, the amount of the cancelled debt constitutes ordinary income to the person who was personally liable for payment of the debt. This ordinary income for the cancellation of the debt is separate from the ordinary loss for abandonment of the property. Pledging the underlying asset as security for the payment of the debt is not necessarily the same as being personally liable for payment of the debt.

So in the case of abandoned property, it would be possible to have both an ordinary loss, for the abandonment of the property, and ordinary income for the debt that is cancelled, if you are personally liable.

- The loss on the abandonment is for the adjusted basis in the property, which could be the purchase price or another basis, depending on how the property was acquired. There could be adjustments to the original basis, such as increases for additions or permanent improvements, and reductions for depreciation deductions or casualty losses.
- The income is for the cancelled balance of the debt. This could be the balance of the original mortgage loan to purchase the property. Or the debt could be another type of loan secured by the property that is abandoned.

How To Report Income from Cancellation of Debt

Income resulting from the cancellation of debt related to business or rental activity should be reported as business income or rental income (for example on Schedule C, Profit or Loss from Business, or Schedule E, Supplemental Income and Loss). Income from the cancellation of a non-business, personal debt would be reported on the "Other Income" line on Form 1040.

Income from the cancellation of debt does not have to be included in taxable income if any of the following apply:

- The cancellation was intended as a gift.
- The debt is qualified farm debt. (The debt is incurred directly in operating a farming business, and at least 50% of gross receipts for the 3 preceding tax years were from the farming business.)
- The debt is qualified real property business debt. (The debt is incurred or assumed in connection with real property used in a trade or business, the debt is secured by the real property, and the property was purchased before January 1, 1993, or on or after that date if the proceeds were used to acquire, construct, or substantially improve real property.)
- You are insolvent or bankrupt.

If the lender is aware that you have abandoned the property that secures the debt, you should receive a Form 1099-A or 1099-C showing information you need in order to report the loss for abandonment and the income for cancellation of the debt.

Foreclosures and Repossessions

A foreclosure or repossession of property on which you have a debt is treated as a sale or exchange for income tax purposes. You may realize a gain or loss on the foreclosure or repossession. This is determined the same way as for a sale or exchange – the difference between the amount realized and your adjusted basis in the property.

Cancellation of Debt

In the case of a foreclosure or repossession, the amount realized is the debt that is cancelled. Part of the amount realized may constitute ordinary income, rather than gain or loss on the foreclosure or repossession. If the amount of debt that is cancelled is more than the fair market value of the property, and you are personally liable for the loan (a recourse loan), the difference is ordinary income, subject to the normal income tax rate that applies in your case. If you are not personally liable for the debt (non-recourse loan), you do not have any ordinary income from the cancellation of the debt.

Gain or Loss

Your adjusted basis in the property is the same as it would be in the case of a sale or exchange – your original basis (cost or other basis, depending on how you acquired the property), plus any additions or improvements, and less any depreciation claimed on the property, casualty losses, or other adjustments.

The difference between the amount realized (the amount of cancelled debt plus any other proceeds you may have received from the foreclosure) and your adjusted basis, is your gain or loss on the foreclosure or repossession. If there is a gain, it could be a personal capital gain (reported on Schedule D) or a capital gain on business property (reported on Form 4797). If it is a loss, it could be a non-deductible personal loss, a loss on property held for investment (Schedule D), or a loss on business property (Schedule 4797).

Non-recourse and Recourse Debt

Non-recourse Debt

In the case of a non-recourse debt, in which the debtor is not personally liable, but the property secures the debt, the amount realized on a foreclosure or repossession is the full amount of the cancelled debt, even if the fair market value of the underlying property is less.

Recourse Debt

If the debtor is personally liable for the debt, the amount realized (for purposes of calculating the gain or loss on the foreclosure or repossession) does not include the amount of the cancelled debt that had to be included in ordinary income. If the fair market value of the underlying property is less than the amount of the cancelled debt, the amount realized includes the cancelled debt only up to the fair market value of the property. In this case, the amount that would have to be included as ordinary income is the amount by which the cancelled debt exceeds the fair market value of the property transferred in the foreclosure or repossession.

In general, in the event of a foreclosure or repossession of property that secures a debt for which you are personally liable, you will have to report as ordinary income the amount by which the canceled debt exceeds the fair market value of the property.

Example 1

You bought a car (for personal use) for $24,000, paying $2,000 down and taking out a loan for the balance of $22,000. You pledged the car as security, but are not personally liable for the debt. After making payments reducing the loan balance by $3,000, you find that you can no longer continue making payments and the lender repossesses the car. The fair market value of the car at that time was $15,000.

- You realize $19,000 on the repossession – the amount of debt that was cancelled ($24,000 price minus $2,000 down payment minus $3,000 payments on loan principal).
- Your adjusted basis is $24,000, your original cost.
- You have a non-deductible personal loss of $5,000 ($19,000 realized minus $24,000 adjusted basis).

If in this same case, you were personally liable for the debt:

- The amount you realize is $15,000, the amount of the cancelled debt ($19,000) up to the fair market value of the car.
- Your non-deductible personal loss is $9,000 ($15,000 realized minus $24,000 basis).
- You have ordinary income of $4,000 from the cancellation of debt ($19,000 unpaid balance of the debt minus $15,000 fair market value of the car). You would report this income as "Other Income" on Form 1040 since the car was a personal asset.

Example 2

You bought rental property for $240,000. You paid 10% down, $24,000, and took out a mortgage loan for the balance of $216,000. You are not personally liable for the mortgage loan. After making payments that reduced the principal amount of the loan by $18,000, you can no longer continue to make payments. At that time, you had taken depreciation of $8,000 on the property. The bank holding the mortgage forecloses on the property when its fair market value is $190,000.

- You realize $198,000 on the foreclosure for the cancellation of debt ($216,000 initial mortgage minus principal payments of $18,000).
- Your adjusted basis is $232,000: your original cost of $240,000 less depreciation of $8,000.
- You have a loss of $34,000 on the foreclosure ($198,000 realized minus $232,000 adjusted basis). Since this loss is on property held for rental, you may be able to claim the loss, subject to at-risk and passive activity loss limitation rules, and subject to your overall capital gains and losses.

If in this same case, you were personally liable for the debt:

- The amount your realize is $190,000, the amount of the cancelled debt ($198,000) up to the fair market value of the property.
- Your loss is $42,000 ($190,000 realized minus $232,000 basis).
- You have ordinary income of $8,000 ($198,000 unpaid balance of the mortgage loan minus $190,000 fair market value of the property). You would report this income as rental income since it was a rental property.

Exceptions to Having to Report Ordinary Income

The same exceptions that apply for abandonment of property, also apply in the case of foreclosures and repossessions. Income from the cancellation of debt does not have to be reported as ordinary income if the cancellation was intended as a gift, the debt is qualified farm debt, the debt is qualified real property business debt, or you are insolvent or bankrupt.