IRS Penalties for Foreclosure and Short Sales are Back in 2014 but Only in Some States

February 26, 2014 - Prior to 2007, if you lost your home through a foreclosure or if you sold it in a short sale, you were very likely to face some significant tax penalties. Federal tax laws require that any amount of money that you borrow but fail to pay back to be considered as ordinary income. So if you borrowed $100,000 and by the time the bank foreclosed on your home, you still owed $50,000, you would have to pay taxes on the $50,000 you failed to pay back. That's on top of any other income you made during the past year. But after the housing market collapsed, and millions of families were facing foreclosure or a short sale, congress passed a temporary law to forgive any taxes like those described above. But starting on January 1, 2014, the old law is back on the books againâ€¦ with one big caveat. Because of quirk within the law, the tax penalties arenâ€™t enforced in every state.

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You might think it odd that people in some states have to pay huge penalties when they lose their home, while those in other states don't. The reason for the discrepancy is because of a definition in the law having to do with something called "non-recourse debt."

According to the IRS website, "A nonrecourse debt (loan) does not allow the lender to pursue anything other than the collateral. For example, if a borrower defaults on a nonrecourse home loan, the bank can only foreclose on the home. The bank generally cannot take further legal action to collect the money owed on the debt. Whether a debt is recourse or nonrecourse may vary from state to state, depending on state law."

Some states allow lenders to get something called a deficiency judgment. In essence, a deficiency judgment is a court order that requires the borrower to pay the lender additional money even after they have been foreclosed on or sold their home in a short sale. If you live in a state that allows this, then your mortgage is a "recourse loan" and any amount that you don't pay would be considered ordinary income; subject to taxation.

But if you live in a state that doesn't allow deficiency judgments on home mortgages, then your mortgage is a non-recourse loan and no tax would be due for the portion of the loan that you failed to pay back.

The laws affecting this can be quite different from one state to another. Some states may not allow deficiency judgments on your primary home, but they are perfectly fine for vacation homes and investment properties. In California, the law forbids deficiency judgments on primary homes or buildings with 4 or fewer units.

There are also some gray areas of the law. For instance you may have to live in the property yourself to make your mortgage a non-recourse loan.

Anyone facing either a foreclosure or a short sale in 2014 really needs to speak with a tax accountant early in the process. Knowing the laws in your state could prevent costly mistakes.
byJim Malmberg
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