

Foreclosures

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Tax Issues On Foreclosure

Nationwide, nearly 6% of all mortgages were in default at the end of 2007. More than 1 million home foreclosures are forecast for 2008 and, depending on rising interest rates and declining property values, 1 ½ million more are projected for 2009.

In California, 8.68% of adjustable rate mortgages were delinquent or in foreclosure at the end of 2007. For the second quarter of 2008 one in every 65 California households received a foreclosure notice (in Nevada that number was one in every 43 households). Second quarter 2008 RealtyTrac numbers show California with the following foreclosure numbers:

Jan-Mar	change from previous	change from first quarter 2007
202,599	19%	198%

With these foreclosure numbers many of our clients will come with questions about the tax impact of losing their properties. New law eases the tax burden for some, but others will be caught by surprise when they have lost their home and still face a tax bill.

Cancellation of Debt (COD) Creates Income

A property owner's gross income, for tax purposes, includes income from discharge of indebtedness or cancellation of debt (COD)[§61(a)(12)]

Taxable as ordinary income. Cancellation of debt income is taxable as ordinary income, even if the COD arises from the sale of a personal residence or other capital gain property. COD income results when any of the borrower's debt is reduced (by compromise, negotiation, or otherwise) for less than the full amount due. COD income most commonly emanates when restructuring or settling a loan [*U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931)].

IRS Reporting. A financial institution that forecloses on a property must file a Form 1099-A with the IRS and provide a copy to the property owner. If the financial institution discounts (reduces) the loan, it must file a Form 1099-C with the IRS and provide a copy to the borrower.

Tax Results When Borrower Loses Property by Foreclosure, Deed in Lieu of Foreclosure, or Abandonment

When a property owner surrenders property to a lender in exchange for debt forgiveness, phantom income from the transaction may be created, either as "income from the discharge of debt" or as "income from the sale of property" or as a combination of both.

Example- Nonrecourse debt: Sharon purchased property in 2005 for \$600,000 with a \$550,000 adjustable rate mortgage (ARM) due and payable in five years (nonrecourse debt). The escalating interest rate on the ARM makes it impossible for Sharon to make her mortgage payments. The lending institution forecloses and the property is sold at a sheriff's sale for \$500,000. Even though the property is sold by the lender for a lesser amount, Sharon has a sales price for tax purposes equal to the debt forgiveness of \$550,000. Thus, Sharon has a \$50,000 loss on the property sale (\$550,000 sales price less \$600,000 basis = \$50,000 loss.) If this is Sharon's personal residence, the loss is not deductible.

Foreclosure of real property secured by NON-RECOURSE debt

Sales price - loan	\$550,000
Basis	\$600,000
Loss	<u>(\$50,000)</u>

Preparer Point: The tax reporting is the same under old law or new law. Nonrecourse loan forgiveness is treated as the sales price of the foreclosed property. Thus the Mortgage and Debt Relief Act of 2007 has no impact on Sharon's taxes.

RECOURSE DEBT- A Foreclosure When the Borrower Is Personally Liable Requires a Two-step Calculation

Generally the deemed "sales price" when a recourse mortgage note is turned back to the lender is the actual debt relief as a result of the foreclosure. But this sales price cannot include any COD income. Therefore, a foreclosure involving a recourse debt must be bifurcated or divided into two parts: (1) income from the discharge of indebtedness and (2) gain (or loss) created by foreclosure [§1.1001-2(a)(2), and (c) (Example 8); Rev. Rul. 90-16, 1990-1 CB 12; *Bressi v. Comm.*, TC Memo 1991-651, 62 TCM 1668].

Comment: The Mortgage and Debt Relief Act of 2007 excludes COD income from the cancellation of "qualified acquisition debt" on a personal residence. Cancellation of other debt on the personal residence as well as debt on vacation homes, investment property and business property still generates taxable income.

The income on the surrender of secured property in exchange for the discharge of recourse debt is calculated as follows:

New law: If the foreclosed property was Sharon's personal residence, the COD income can be excluded.

Character of the gain or loss in a foreclosure. Foreclosure gain or loss is governed by the normal gain or loss rules; that is, a capital asset creates a capital gain or loss, business assets create capital gain and ordinary loss, and dealer realty creates ordinary gain and loss. Sadly, foreclosure on a personal residence may create a nondeductible loss!

Exception to the COD Income Rule- §108 Relief

If the cancellation of debt (in whole or in part) occurs (1) in bankruptcy or (2) to an insolvent borrower, this normally taxable income becomes *not* taxable [§108(a)(1)].

Excluding COD in a bankruptcy case. Income from the discharge of debt incurred by a taxpayer in bankruptcy is excluded from income altogether, provided the bankruptcy case is not dismissed prior to debt discharge. However, to the extent available, a certain amount of a borrower's future tax benefits (called tax attributes) will be reduced. This exclusion from income is allowed, though, regardless of whether the amount of such income exceeds the borrower's future tax benefits (tax attributes) available for reduction [§108(a)(1)(A); §108(b)].

Excluding COD when the taxpayer is insolvent. Gross income does not include COD income when the borrower is insolvent. However, the amount excluded cannot exceed the amount by which the borrower is insolvent. Certain of the borrower's future tax benefits (i.e., tax attributes) must be reduced by the amount of income excluded under this insolvency exception. If a taxpayer is bankrupt and insolvent, only the bankruptcy exclusion applies. If the borrower remains insolvent after the discharge, all income from the discharge is permanently excluded, regardless of whether the amount of such income exceeds the amount of future tax benefits (i.e., tax attributes) available for reduction [§108(a)(1)(B); §108(a)(3); §108(b)].

What is insolvency? Being insolvent means the investor's liabilities exceed the fair market value (FMV) of his or her assets determined immediately before the discharge (i.e., FMV assets less liabilities equals a negative number). Nonrecourse debt is included in this calculation only when it is involved in the debt discharge transaction itself, and in such cases only the amount discharged is counted [§108(d)(3); Rev. Rul. 92-53, 1992-27 IRB].

Ordering rule for reduction of future tax attributes. In the absence of an election to first reduce depreciable basis, future tax benefits (tax attributes) of the borrower shall be reduced to the extent of debt discharge income (or its equivalent) in the following order:

Example: Robert purchases a \$1,000,000 office building financed by a \$900,000 mortgage from the Last Chance S&L and \$100,000 of his own cash. Afterward, the property value plummets to \$700,000 and Robert goes to his friendly loan officer and says "You can have this pig back." The loan officer, as an alternative, offers to reduce Robert's loan from \$900,000 to \$700,000 if he continues to make the agreed monthly payments. Robert accepts. If Robert properly elects, he may simply reduce his depreciable basis by \$200,000 and avoid COD income.

Required qualifications. *Qualified real property business indebtedness (QRPBI)* is debt that meets the following three requirements:

1. The debt is incurred or assumed in connection with the acquisition of real property used in a trade or business (but qualified farm debt cannot be QRPBI).
2. The debt is secured by that real property.

Tax Tip: Secured debt is defined as a security instrument (such as a mortgage, deed of trust, or land contract), and (1) the qualified property is specific security for the payment of the debt; (2) in the event of default, the property could be subject to the satisfaction of the debt; and (3) it is recorded [§1.163-10T(o)(1)].

3. The taxpayer makes a proper election.

The election must be made on Form 982. Regulations provide that Form 982 must be attached to the return as originally filed for the year in which the discharge occurred. However, a taxpayer who can show reasonable cause can file the election with an amended return. The revised form includes a new check box to make the election (box 1d) and a line (line 4) to indicate the amount to be applied against depreciable basis [IRS Ann. 94-11, 1994-3 IRB and Temp. regulation 1.108(c)-1T].

Cancellation of Acquisition Indebtedness on Principal Residences Excluded from Gross Income

Mortgage Forgiveness Debt Relief Act of 2007

Foreclosures are up dramatically. The estimate is that 2.5 million homes will be foreclosed upon in the next 2 years. To a great extent this is the result of the "sub prime lending" frenzy in the past few years that qualified marginal borrowers for 100% financing (no equity), the use of adjustable-rate mortgages (now resetting monthly mortgage payments substantially higher) and refinances. Regardless of why the foreclosure rate is up, the tax consequence of losing one's property will come as a surprise to many.

Comment: Even the IRS is getting into the act with the creation of a webpage to help explain the mostly negative tax ramifications upon foreclosure ([IR-2007-159 Q&A](#)).

Warning: Homeowners who refinanced their principal residence mortgage to pay off personal credit card debts, car loans or for other personal uses are not entitled to this new exclusion and will have cancellation of debt income.

Basis Reduction

The basis of the individual's principal residence is reduced by the amount excluded from income, the theory being that his reduction will be subsequently reported as additional gain upon a future sale. Of course, this would only happen if the gain exceeds \$250,000/\$500,000 MFJ.

Example. Karen bought her home in Riverside California for \$600,000. She financed the purchase with a \$540,000 first mortgage and a \$60,000 second mortgage. The value of her home has dropped below the first mortgage balance. Karen talks the second mortgage lender into writing off its \$60,000 note. Thus she has COD income of \$60,000 and she'll receive a form 1099C from the lender. The \$60,000 COD can be excluded under the new law but Karen's basis in her home will be reduced by the excluded amount. Her basis will be \$540,000 rather than \$600,000.

Bankrupt or Insolvent Taxpayers

The exclusion does not apply to a taxpayer in a Title 11 bankruptcy case; instead the present-law exclusion at §108(a)(1)(A) applies. In the case of an insolvent taxpayer not in bankruptcy, the exclusion under the bill applies unless the taxpayer elects to have the present-law exclusion at §108(a)(1)(B) apply.

Discharge of Indebtedness in Exchange for Services Rendered

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender.

Short Pay or Short Sales—How Are They Taxed?

One phenomenon in a declining residential mortgage market is dubbed a "short pay" or a "short sale," that is, the home is sold for less than ("short of") what is owed on the mortgage. Property advertisements sometimes refer to it as a "pre-foreclosure" sale. While the home is marketed by the mortgage holder in a foreclosure, it is marketed by the homeowner in a short sale, generally with the disclosure "subject to lender approval." Often the lender agrees to the sale of mortgaged property by the debtor for an amount less than the outstanding debt. In addition, the debtor may be required to pay some cash to the lender.

Comment: In a short pay transaction, the lender, not the property owner, makes the ultimate decision to sell. For the property owner, a short sale is sometimes better for their credit rating than going through foreclosure proceedings. For the lender, the short sale alternative cuts their losses faster than the protracted foreclosure process.

Checklist for Exclusion of Cancellation of Home Mortgage Indebtedness	
Must be principal residence as defined under §121	✓
Must be acquisition indebtedness as defined in §163 ✓original or refinanced debt ✓used for acquisition, construction or improvement of principal residence ✓debt not used for personal purposes ✓secured by the principal residence ✓recourse debt ¹ ✓under \$2 million	✓
Homeowner has not filed bankruptcy	✓
If homeowner is insolvent, may elect to use this provision	✓
Cancellation is not for personal services rendered	✓

New: Form 982 Revised to Exclude Mortgage Forgiveness Debt (IR-2008-17)

IRS issued a revised Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, to allow for the reporting of the home mortgage exclusion and the basis reduction. According to the IRS, in most cases, eligible homeowners will only need to fill out a few lines on Form 982 (specifically, lines 1e, 2 and 10b).

California Cancellation of Debt

California Senate Bill 1055, enacted September 25, 2008 partially conforms the California R&TC to the Mortgage Forgiveness Debt Relief Act of 2007. There remain several key differences, however, between California and Federal law.

- California applies the exclusion for qualified principal residence debt only for tax years beginning January 1, 2007 through December 31, 2009
- California limits the term "qualified principal residence debt" to \$800,000 (\$400,000 in the case of marrieds/RDPs filing separate)
- California limits the exclusion from income to \$250,000 (\$125,000 in the case of marrieds/RDPs filing separate)

¹ Non recourse loans forgiven in foreclosure are treated as the sales price of the property. Thus no cancellation of debt income occurs. The new law is to protect homeowners with recourse financing from cancellation of debt income.