



Debt Relief, Recourse Mortgages and Tax Research
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Exclusion of Debt Forgiveness Under §108

We had a case come down recently that gets into an issue that was dealt with in the *Mortgage Forgiveness Debt Relief Act of 2007* that deals with the issue of when a mortgage holder takes a piece of property in exchange for the mortgage outstanding on the property. While the new provisions of that bill have changed the rules, they have only done so for limited cases where the debt in question is acquisition debt and the property is a principal residence—and even then, the taxpayer has the right to elect to move the “older” insolvency rule into the primary position for relief.

So it's important to understand the issues in the Keith case because a number of taxpayers who face foreclosure currently are in the position because they borrowed against the increased value of their home during the real estate boom,

others would find they might face a taxable gain under §121 and others may be losing investment properties that won't qualify for relief.

Mortgage Debt in Exchange for A Property

The first key issue you need to examine when a property is taken back by the mortgage holder is whether the debt in question is *recourse* or *nonrecourse*. In the case of nonrecourse debt, the entire balance of the debt is considered the sales price of the property and the underlying current day fair value isn't an issue. That's because there is a pre-existing binding agreement that the mortgage company would accept the property in full satisfaction of the debt—thus, it's simply, for tax purposes, an exchange of the property for the debt balance.

As an aside, note that the provisions of the *Mortgage Forgiveness Debt Relief Act of 2007* would not affect this transaction, which can result in gain recognition if the amount of gain is in excess of the §121 limits or the taxpayers do not qualify for §121 relief from the recognition of gain.

However, if the debt is recourse, then we have two transactions. Under that mortgage, the holder of the mortgage only credits the value of the property taken against the balance of the debt, and the debtor is still liable for the balance. In many cases the lender doesn't pursue that additional balance, since it's not terribly likely they'll be able to collect it. However, the fact that they could creates a second transaction—the forgiveness of the underlying debt—that is accounted for separately from the sale.

In that case, you have two transactions:

- The sale of the property for an amount equal to its fair value at the date it was taken. This sale is accounted for under the standards rules of §1001 for computing a gain or loss (with the loss on a principal residence considered nondeductible) and if the property is eligible, the rules of §121 for potential exclusion of any gain
- A forgiveness of indebtedness taxable under the rules of §108. Under §108 the amount is ordinary income, but is potentially excludable if the debt is discharged under bankruptcy, to the extent the taxpayer or, beginning in 2007, if the amount involves qualified principal indebtedness as defined in §108(a)(1)(E)

This bifurcated treatment is the method prescribed in Reg. §1.1001-2, which provides

(2) Discharge of indebtedness.

The amount realized on a sale or other disposition of property that

secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and section 1.61-12(b)(1).

As the regulation notes, IRC §61(a)(12) specifically indicates that the discharge of indebtedness creates taxable income. This general rule is subject to the exceptions found in §108, which provides a list of, after the *Mortgage Forgiveness Debt Relief Act of 2007*, five potential exceptions at §108(a)(1):

(a)(1) IN GENERAL. --

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if --

- (A) the discharge occurs in a title 11 case,
- (B) the discharge occurs when the taxpayer is insolvent,
- (C) the indebtedness discharged is qualified farm indebtedness,
- (D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or
- (E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2010.

A "title 11" case is what is more commonly referred to as a discharge in bankruptcy and the last three deal with special classes of debt that we won't consider in this podcast (though the last one was dealt with in the podcast on the new laws that was posted to the web on December 27).

The insolvency exception is the one of interest today. Note that this exception is limited in a case where the discharge of this particular debt takes the taxpayer from a condition of insolvency to one of being solvent. §108(a)(3) provides:

(3) Insolvency exclusion limited to amount of insolvency

In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

Thus, if a taxpayer has the following net worth prior to foreclosure:

Assets (at fair market value)	
Real property (basis 400,000)	\$ 500,000
Other Assets	<u>200,000</u>
<i>Total Assets</i>	<u><u>\$ 700,000</u></u>
Liabilities	
Mortgage on real property	\$ 600,000
Other unsecured debts	<u>190,000</u>
<i>Total Liabilities</i>	<u><u>\$ 790,000</u></u>
Net Worth	<u><u>\$ (90,000)</u></u>

If the mortgage holder takes the property, it would reduce the debt by the \$500,000 that represents the fair value of the property, creating a gain on sale or exchange of \$100,000 (\$500,000 less the \$400,000 basis), with \$100,000 worth of debt remaining.

If the mortgage holder forgives that \$100,000 debt, that \$100,000 would be income under §61(a)(12), subject to potential exclusion under §108. The taxpayer is insolvent at the time of the discharge, so §108(a)(1)(B) would apply. However under §108(a)(3) the exclusion would be limited to the extent that the debt forgiven (\$100,000) exceeds the \$90,000 that represents the amount the taxpayer is insolvent.

The qualified principal residence indebtedness exception of §108(a)(1)(E) might come into play to exclude the second gain. By default, even if a taxpayer is solvent, §108(a)(1)(E) will apply in lieu of §108(a)(1)(B), but a taxpayer can elect to have §108(a)(1)(B) apply in lieu of the qualified residence debt discharge exclusion.

A taxpayer might prefer that if, for instance, a taxpayer had a basis that was less than the acquisition debt due to a previous gain deferral or the debt forgiveness occurred due to a reworking of the taxpayer's loan where the outstanding debt was reduced. That is because §108(h)(1) requires that the basis of the residence itself be reduced by the excluded gain, while otherwise you'd use the ordering rules of §108(b) to reduce tax attributes, which would put a number of tax attributes and any depreciable property in the "line of fire" to get a reduced basis before the residence—but the reduction wouldn't take place until after the tax had been computed for the current year.

While it may not often be advantageous to make use of this provision, it is

possible and you need to be aware of this issue.

But, as noted, there are lots of cases where the new law won't help. In the example cited above, if the \$400,000 was the original acquisition price of the property and the taxpayer had refinanced in recent years to pull out equity for purposes other than to improve the residence, then the amount discharged wouldn't be qualified principal residence indebtedness—in which case the insolvency exception may be the only option to potentially exclude the gain.

Note that if the mortgage was nonrecourse, then the new provision also would not apply. In that case, the property would be sold for \$600,000, with a \$200,000 gain. If the taxpayer did not qualify for a §121 exclusion (or at least not a full one), then there could be a higher tax due in the case of a nonrecourse mortgage since there would be no debt discharge that §108 could reach.

The Keith Case

The case of *Keith v. Commissioner*, TC Summary 2007-214 shows that the IRS can really get “off the tracks” all the way to Tax Court. The unfortunate fact is that the taxpayers in this case had to actually end up going to court to get the IRS to discover their position was one that at variance with the current state of the law—a state that had existed for 27 years.

In court, the IRS relied on what the court dismissed solely as “inapplicable regulations” and case law that had been superseded by a law change 27 years ago to take the position that a taxpayer, to obtain the benefit of the insolvency exception to recognition of forgiveness of indebtedness income, had to be insolvent both before and after the forgiveness.

In the case, the taxpayers' home was taken in foreclosure. They owed \$112,035 on a mortgage at the date the property was taken by the mortgage holder. The holder offset \$90,000 of fair value of the property against the debt, resulting in a remaining balance of \$22,035. While it was a recourse debt, the lender did not seek to collect on that remaining balance by obtaining a state law judgment, and so issued a 1099-C for the \$22,035 to reflect the debt forgiveness (the \$90,000 would represent the “sales price” of the residence for a Section 121 computation).

The taxpayers had assets worth \$133,715 and outstanding liabilities (before forgiveness) of \$155,505.59. The IRS conceded these figures were correct, thus all parties agree that before the lender forgave the \$22,035, the taxpayers were insolvent to the extent of \$21,790.59. The IRS contended that since they were not insolvent after the discharge (they now had assets of a whopping \$244.41 in excess of their liabilities), they could not obtain Section 108 relief under the insolvency provision.

The Tax Court knocked this argument down quickly. The noted the IRS was "relying upon an inapplicable regulation and precedent from a case superseded by the enactment of section 108(a)(1)(B)" (which it notes in a footnote was enacted back in 1980) in support of its position. The Court points out that §108(a)(3) provides that "the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent" which clearly establishes the total inclusion should have been \$224.41. Since the taxpayers had excluded the entire amount, the IRS "won" an assessment--but far less than the \$12,448 deficiency.

The IRS had also argued for a substantial underpayment penalty under §6662(a) of \$2,490. The Court notes that given its ruling " the understatement will be far less than the amount required for the imposition of the penalty" and thus gets rid of the penalty in its entirety.

Conclusions

Given the standards imposed on practitioners for positions under §6694(a), I find this case especially bothersome. It is interesting that no one at the IRS involved with the case noticed that the basic research underlying their position was as fundamentally flawed. My guess is that this position just started snowballing and also flew under the radar for review as the case moved forward.

As well, to be fair, we don't know from the opinion exactly what the IRS saw as potential regulatory support or the case they were trying to apply to the case. But given the clarity of the Code itself in this area, it seems clear that it would be difficult to find any items to reverse what is, to this eye, the clear language of the underlying Code.

Regardless of how this happens, we do need to be aware that it's not that difficult to get sidetracked by our own research, especially when we know the answer we want before we start doing the research. And, frankly, normally it's clear what answer the client would prefer and therefore the news that will be easier to deliver.

How do you guard against this? You have to go back to basics and remember that we should be able to start our defense of any position using the IRC itself, absent a treaty or Constitutional issue. It's easy to forget this basic rule when working with editorial reference materials (including articles such as this one on a specific issue) that discuss court cases, rulings, etc. and concentrate instead on the specific case or ruling.

However, you always should check any authority you decide to make use of to determine if it is still valid. For instance, even if working from the Code, you have to check how "up to date" your source is. Even though the President signed the new law before Christmas, as of December 30 (when I'm checking this) both the

CCH and Tax Analysts online versions of the Code in my reference materials don't yet have the new law incorporated (though CCH does have a section in their new law manual that shows you how the provisions that were modified will read after incorporating the law). And CD based versions of the IRC (like that in my Tax Analysts OneDisc subscription) will not have this incorporated until their February editions. Printed versions will, obviously, be even more susceptible to law changes.

For court cases, regulations, and other "lower levels" of authority, you need to determine if the law has changed since the authority was issued. As is noted in this case, a decision from before the 1980 changes to §108 may render the case useless for analyzing a current situation. Similarly, many regulations have not been updated for law changes that were made since they were issued, meaning where the regulation contradicts current law you have to follow the law.

Editorial services attempt to compensate for these issues, but even if they get the details perfect you still have to look at how often they are updated and when they were last issued. Most desktop reference materials (the *CCH Master Tax Guide*, *The Tax Book*, etc.) are only published annually and, at best, issue some "bulletins" for some updated material. Even the continuously updated online items (like *RIA Federal Tax Coordinator on Checkpoint*, *Tax Analyst's Federal Tax Research Library Online*, etc.) still take some time to incorporate developments into their text.

Sometimes the best we do is use the most current material we have access to (for me normally online services from CCH and Tax Analysts) along with keeping up with daily news updates from my tax services, or at least reviewing those in recent weeks for developments in the area I'm looking at, just to help find developments that may not have yet been incorporated into the main text of the service I'm using.