

DEBT, FORECLOSURES AND THE TAX LAW

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Foreclosure and Tax Consequences

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DEBT, FORECLOSURES AND THE TAX LAW

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In today's economic environment, issues relating to debts and foreclosures have become increasingly important for tax professionals to deal with. In today's presentation we are going to look at the various

I. LOSS OF PROPERTY VIA REPOSSESSION

We will first consider the matter of when a taxpayer gives up property either voluntarily or involuntarily when the taxpayer finds him/herself unable to meet obligations under the debt. The nature of the debt underlying the property will be crucial in determining which provisions of the tax code apply in determining the tax consequences of the transaction.

Two key provisions impact taxation in this area. The first is IRC §1001, which deals with gain on sale or exchange of property. In a repossession, a property is exchanged for a reduction in the amount of debt outstanding. Per Reg. §1.1001-2(a)(1) the debt given up in exchange for the property is considered proceeds of the sale.

However, Reg. §1.1001-2(a)(2) provides that the amount considered as proceeds of sale does not include amounts that are discharge of indebtedness under §61(a)(12). What this has the effect of doing is causing Section 61 to override the Section 1001 proceeds treatment if the lender gives up a right to be paid back a portion of the debt.

As well, the §61(a)(12) provision can arise if there is no sale, but only a reduction of debt.

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In Publication 4681 the IRS provides the following worksheets for computing the two types of income before we consider any relief provisions:

Table 1-1. Worksheet for Foreclosures and Repossessions

Keep for Your Records



Part 1. Figure your ordinary income from the cancellation of debt upon foreclosure or repossession. Complete this part only if you were personally liable for the debt. Otherwise, go to Part 2.	
1. Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	_____
2. Enter the fair market value of the transferred property	_____
3. Ordinary income from the cancellation of debt upon foreclosure or repossession.* Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	

Part 2. Figure your gain or loss from foreclosure or repossession.	
4. If you completed Part 1, enter the smaller of line 1 or line 2. If you did not complete Part 1, enter the amount of outstanding debt immediately before the transfer of property	_____
5. Enter any proceeds you received from the foreclosure sale	_____
6. Add line 4 and line 5	_____
7. Enter the adjusted basis of the transferred property	_____
8. Gain or loss from foreclosure or repossession. Subtract line 7 from line 6	

A. Nonrecourse Debt

In the case of a nonrecourse debt, only §1001 comes into play, as the lender only the right to take the property in satisfaction of the debt. In this fact pattern the gain/loss rules come into play, and potential relief provisions under §108 are unavailable.

Example 1: Joe bought a rental property for \$200,000 in 2004, putting down \$10,000 and borrowing \$190,000 on a nonrecourse debt. In 2008 the value of the property had dropped to \$100,000 when Joe defaulted on the debt. At the time the balance of the debt was \$180,000, and the depreciation taken to date was \$10,000.

Joe has a net §1031 loss of \$10,000 with a sales price of the outstanding debt (\$180,000) less the basis of the property (\$200,000 - \$10,000 depreciation taken to date, or \$190,000). The fair value of \$100,000 is not a relevant figure in this case because the lender and borrower had agreed that in the event of default, the lender had to accept the building in satisfaction of the debt.

This isn't a problem if the sale produces a loss, but can be a problem if the

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exchange transaction produces a gain when the underlying fair market value of the property has dropped well below what was paid. The taxpayer feels that they've lost on the transaction, but that is not the result.

Example 2: This time, assume that Joe has taken depreciation of \$40,000 on the property, lowering its adjusted basis to \$160,000. Now the \$180,000 of debt given up in exchange for the property is in excess of the property's basis, generating a §1231 gain on disposition of \$20,000. In this case, that gain would be subject to the 25% maximum rate on unrecaptured §1250 depreciation.

Even if Joe was in bankruptcy or was insolvent, this gain would still be taxable to him. The same would be true if the debt was qualified principal residence indebtedness or qualified real property indebtedness. As this is a nonrecourse debt, no discharge of indebtedness income under §61(a)(12) takes place, and the relief provisions of §108 are not available to Joe.

The test of whether a debt is recourse or nonrecourse is determined under the applicable state law based upon the agreement between the lender and the taxpayer.

The sale is then subject to tax like any other sale, potentially subject to gain exclusion under §121 if the property is a principal residence and meets the applicable, or perhaps an ordinary loss under §1031 (or a disallowed personal loss).

B. Recourse Debt

If a debt is recourse, then the transaction is split into two transactions. As noted above, the fair value of the property taken, which reduces the outstanding obligation to the lender, is treated as the proceeds from the sale or exchange, subject to the same general rules noted.

If the lender does not pursue collection of the remaining balance of the debt, that becomes forgiveness of debt under §61(a)(12). That amount will be ordinary income unless it meets one of the gain exclusion provisions of §108.

Example 3: Joe bought a rental property for \$200,000 in 2004, putting down \$10,000 and borrowing \$190,000 on a recourse debt. In 2008 the value of the property had dropped to \$100,000 when Joe defaulted on the debt. At the time the balance of the debt was \$180,000, and the depreciation taken to date was \$10,000. The lender agreed to reduce the outstanding liability on the property to its fair value in order for the property to be sold.

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Joe has a net §1031 loss of \$90,000 with a sales price set at the fair value of the property (\$100,000) less the basis of the property (\$200,000 - \$10,000 depreciation taken to date, or \$190,000). The remaining \$80,000 of the debt that the lender did not pursue collection on becomes an ordinary gain, and if Joe does not qualify for a relief provision under §108 will be taxable to him.

In this case it appears that, at worst, Joe ends up with an offsetting gain and loss. But consider the next example.

Example 4: Joe bought a vacation property for \$200,000 in 2004, putting down \$10,000 and borrowing \$190,000 on a recourse debt for which he was to pay interest only, with a balloon due in 2008. In 2008 the value of the property had dropped to \$100,000 when Joe defaulted on the debt when he was unable to obtain financing to pay the balloon payment due on the original note. The lender does not pursue collection of the remaining balance of the debt that was not satisfied with the value of the property.

Joe has a nondeductible loss of \$100,000 on the sale of the property (\$100,000 sales proceeds reduced by the \$200,000 basis). The loss is nondeductible due to the property being personal use property.

However, the \$90,000 discharge of indebtedness is still ordinary income to Joe under §61(a)(12) and if Joe cannot qualify for an exclusion under §108 will be taxed to him as ordinary income.

Or, for a bigger potential problem:

Example 5: Bob and Mary bought their principal residence back in the 1970s for \$40,000 and had paid off the mortgage entirely by the end of the 1990s. He saw the home rise rapidly in value during the early part of this decade.

He decided that he needed to take cash out of the home since “everyone was doing it”, so he borrowed \$400,000 against the home's equity in 2004 on an interest only loan. As with the last example, this loan had a balloon payment due in 2008.

Now Bob finds that he cannot get the loan refinanced and surrenders the property in exchange for the loan. The loan was a recourse loan and the home is now worth \$200,000 when the lender takes it back.

Bob has a sale for \$200,000 that produces a capital gain of \$160,000. That gain is excluded under §121, as they owned and lived in the house for the two years

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prior to the date it was taken to satisfy the mortgage.

The remaining \$200,000 of debt is forgiven by the lender, and that results in \$200,000 of ordinary income. This is true despite the fact that if Bob and Mary had sold the home for \$400,000, the entire gain would have been excludable from their income under §121. As well, since the debt was not used to acquire or substantially improve the residence, this loan will not qualify as “qualified home residence interest” under §108, so Bob and Mary will need to look at the insolvency provisions of §108 for any possible relief.

Due to the various potential tax treatments of the sales gain/loss transaction and the provisions of §108 for exclusion of debt forgiveness, the results can be radically different for a taxpayer depending on whether a debt is recourse or nonrecourse—and it's not possible to generalize and state that one type is “better” than the other from a tax perspective.

C. Section 108 Gain Exclusion Provisions

As noted earlier, §62(a)(12) specifically mentions relief from indebtedness as taxable income and it is taxed as ordinary income unless a specific relief provision applies.

The main relief provision for discharge of debt is found in IRC §108, which allows taxpayers who meet certain requirements to exclude from income some or all of certain types of debt relief.

Taxpayers who claim relief under §108 file Form 982 to claim the relief and to document the reduction of tax attributes that take place when §108 comes into play.

Section 108 provides the following exclusions:

108(a)(1) IN GENERAL. --

Gross income does not include any amount which (but for this subsection) would be includable 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,

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(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, 2013.

We will be looking at four of the five exclusions here (I will bypass the qualified farm indebtedness issue for today's presentation, though you should remember it is there if it appears applicable to your client.

The big negative of the use of §108 is that a taxpayer will be required to reduce certain tax attributes (such as net operating losses or the basis of depreciable property) in exchange for this relief.

1. Insolvency and Bankruptcy

The bankruptcy and solvency exceptions are often viewed as one, but they are two separate provisions under the law. §108(a)(1)(A)'s reference to "Title 11" is a reference to cases under the Bankruptcy Code of the United States. To be eligible for this relief, §108(d)(2) requires that the taxpayer be "under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court."

If there not a formal discharge in bankruptcy (which is often the case), then taxpayers have to look to the insolvency provisions to obtain relief. Debt relief is excluded from income to the extent that a taxpayer is insolvent at the time [§108(a)(3)].

Example 6: Linda had an outstanding unsecured debt of \$20,000 for which the lender agreed to accept \$5,000 as payment in total satisfaction of the debt, relieving Linda of \$15,000 of debt. This debt is the only debt that Linda held

Prior to the discharge, the total value of Linda's assets was \$10,000. Thus, prior to discharge, she was insolvent by \$10,000. Thus, \$10,000 of her debt relief is eligible for exclusion under §108(a)(1)(B), as limited by §108(a)(3). The remaining \$5,000 is subject to tax as ordinary income.

Computing the taxpayer's insolvency is not without its own issues. The IRS position is that a taxpayer must include all assets when determining the taxpayer's solvency, including those assets that could not be reached in bankruptcy. In TAM 199935002 the IRS outlined that position, noting it was consistent with their view of Congressional intent and in *Carlson v.*

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Commissioner, 116 TC No. 9, the Tax Court held that “the definition of that term which Congress adopted for purposes of section 108 does not specifically exclude assets of a debtor that are exempt from the claims of creditors under applicable State law or any other title 11 exempt property in determining whether the debtor is insolvent.”

Thus, taxpayers who want to make use of the insolvency provision of §108 will have to count otherwise exempt assets in the determination of whether the taxpayer is insolvent.

As well, CPAs may face a special issue in this regard. *Statements on Standards for Valuation Services No. 1* which took effect on January 1, 2008 imposes standards on CPAs who value “subject interests” which includes interests in closely held businesses and intangible assets, both of which may factor into the taxpayer's solvency calculation. Should the client ask the CPA to assist in determining a value, SSVS No. 1 would have to be complied with.

In the Appendix to SSVS No. 1 at ¶46, the matter is explicitly dealt with as follows:

45. *Illustration 12h.* A member has been engaged to provide advice to a company regarding the tax planning for income from discharge of indebtedness under IRC section 108. The company has advised the member that the company will be able to negotiate a settlement in complete satisfaction of an obligation at 30 cents on the dollar. Is this a valuation engagement subject to the Statement?

46. *Conclusion.* It depends. Under IRC section 108(a), gross income of the company excludes income from discharge of indebtedness only under certain circumstances. One of those circumstances is the insolvency of the company. Under IRC section 108(d) (3), insolvency results from an excess of liabilities over the fair market value of assets. If (a) the company must rely on the insolvency provisions of IRC section 108; (b) one or more of the assets for which value is relevant under IRC section 108 is a subject interest (that is, a business, business ownership interest, security, or intangible asset); (c) the company or a third party does not provide the valuation; and (d) the member applies valuation approaches and methods, and uses professional judgment to value the subject interest(s) for purposes of the IRC section 108(d)(3) insolvency determination, the Statement applies.

Tax attributes must be reduced if §108's insolvency or bankruptcy provisions are invoked to escape taxation on the cancellation of indebtedness. Unless a taxpayer elects to first reduce the basis of

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depreciable property, the attributes are reduced in the following order until the entire cancellation income not recognized has been absorbed *after* figuring the income tax liability for the year of discharge:

1. Net operating losses: first the NOL for the current year is reduced and then any NOL being carried into the current year. The reduction is one dollar of NOL carryover is reduced for each dollar of excluded cancelled date. [§108(b)(2)(A)]

2. General business credit carryover: General business credit carryovers to or from the current year are reduced at the rate of 33 1/3 cents for each dollar of debt forgiveness [§§108(b)(2)(B) and 108(b)(3)(B)]. The reduction is made in the same order the credits are taken into account for the current year.

3. Minimum tax credit: The minimum tax credit available at the beginning of the following year is reduced, again by 33 1/3 cents for each dollar of applied debt forgiveness.

4. Capital loss. First the current year capital loss carryover is reduced, followed by loss carryovers into the current year.

5. Basis in Property: Basis reductions are governed by §1017 and the regulations under that section. Any basis reduction will be treated, upon later sale of the property, in the same fashion as depreciation available for recapture, converting them to ordinary income. That is true even for personal use property or real property that normally would not generate ordinary income upon sale.

Basis is reduced, per §1017's regulations, in the following order:

1. Real property used in the trade or business or held for investment that secured the debt in question
2. Personal property used in the trade or business that secured the canceled debt
3. Property other than inventory, accounts and notes receivable or real property held primarily for sale to customers
4. Inventory, accounts and notes receivable and real property held primarily for sale to customers
5. Personal use property

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6. Passive Activity Losses and Credit Carryovers: Again, loss carryovers are reduced dollar for dollar, while credit carryovers are reduced at the rate of 33 1/3 cents per dollar.

7. Foreign tax credit carryovers. Again we use the 33 1/3 cents per dollar.

If you get this far and still have cancellation exclusion not used up, nothing more needs to be done—the taxpayer will not end up suffering any negative tax consequences down the line from that part of the debt.

The taxpayer can elect to first reduce the basis of depreciable property in lieu of reducing the basis of any attribute that occurs earlier in the list. The taxpayer can also elect to treat real property held for sale to customers as if it were depreciable property for these purposes. Once the election is made it can only be revoked with the consent of the IRS.

1. Qualified Principal Residence Indebtedness

As noted above, when a taxpayer's residence is taken to pay off the mortgage, the property is worth less than the balance of the mortgage, the mortgage was not nonrecourse and the lender does not pursue the taxpayer to collect the remaining balance on the loan, there are considered to be two transactions.

1. There is a sale of the residence for its fair value. That sale is taxed under §121, with gain potentially excluded if the taxpayer meets the 2 out of 5 year tests for both ownership and use.
2. Since the mortgage is a recourse mortgage, the taxpayer owes the lender the balance of the loan. However, quite often the lender recognizes that it will not be able to collect that balance and forgives the rest of the debt. Under §108 that amount is ordinary income to the taxpayer unless the taxpayer qualifies for exclusion under the provisions of §108.

The latter results in a significant tax bill unless the taxpayer can show they are insolvent both before and after the forgiveness.

Congress has granted relief to certain taxpayers facing that situation for 2007-2009. The §108 gain is excluded from income so long as:

- The residence was the taxpayer's principal residence as defined in §121 [§108(h)(5)]

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- The debt is no more than \$2,000,000 of acquisition indebtedness as defined in §163(h)(3)(B) (ignoring the \$1,000,000 limit in that section) [§108(h)(2)]
- The exclusion does not apply if the debt forgiveness is given in exchange for services performed for the lender or any other reason not related to the homeowner's financial condition [§108(h)(3)]

Example 7: Jim and Mary purchased their personal residence in March of 2006 for \$1,500,000 with an interest only loan that was recourse for \$1,400,000 after putting \$100,000 down. The house was at all times used as their principal residence while they owned it. In June of 2008 their house was foreclosed upon by the lender when the house was worth \$750,000.

They have a gain on cancellation of indebtedness of \$650,000 which they are eligible to exclude from their income under IRC §108(a)(1)(E) since the debt meets the requirements for being qualified residence indebtedness as defined at §108(h).

Any amount excluded under this provision reduces the basis of the residence of the taxpayer (though not below zero). However, a taxpayer can elect to have the solvency provisions apply instead of these rules which would preserve the basis in the residence while reducing other tax attributes as noted earlier.

If a debt is only partially qualifying residence indebtedness, only the amount of the loan in excess of the amount not constituting qualified residence indebtedness is eligible for relief under this provision.

Those provisions introduce some issues in qualifying for this relief. As well, it's important to note that due to the fact that many taxpayers got into financial trouble through borrowing against increases in value in their property, this provision is going to be inapplicable or only partially applicable in many cases.

Principal Residence Requirement

The first key requirement is that the taxpayer has to show the property in question was the taxpayer's principal residence, with the term being defined by the rules found in §121 for such exclusions (see Reg. §1.121-1(b)(2)).

There's not a truly simple test for a principal residence under §121 and

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the applicable regulations. However, the taxpayer in *Guinan v. United States* (2003-1 USTC ¶150,475, 91 A.F.T.R.2d (RIA) 2003-2174) discovered what did not work.

In *Guinan* the taxpayer had two residences, one in Wisconsin and one in Arizona. The taxpayer sold the Wisconsin residence at a gain and sought a refund of taxes paid, claiming the Wisconsin residence was their principal residence despite the fact that for a number of years they had filed as full year Arizona residents (with no tax filing in Wisconsin) and appeared to spend more days in Arizona.

While the *Guinan* case covered a return filed prior to the issuance of the regulations under §121, by the time the case came to trial the regulations were available and the trial judge referred to them in determining based on the facts of this case that the Guinans had not used the Wisconsin residence as their principal residence for the required time period.

The regulations don't give any absolute answers, but suggest strongly that a place where the taxpayers spends most of their time will be deemed to be their principal residence. For Section 121 purposes, the regulations make it clear the day counting test takes place once per year.

Other factors do also have an impact, including where it appears the taxpayer has closer connections, including personal and family connections, as well as business ties. And, frankly, the fact that the Guinans claimed to be full year Arizona residents almost certainly did not help their case when they tried to claim principal residence status for their Wisconsin property.

Clearly the principal residence requirement is going to cause issues for taxpayers with more than one residence. As well, a taxpayer who has spent years attempting to claim residency in any state but California (something that seems to be a pastime of a number of individuals) may find that position might come back to haunt them if they give up their California home due to being upside down on the mortgage.

Acquisition Debt

The next big hurdle is that the relief is limited to \$2,000,000 of *acquisition indebtedness* as defined in §163(h)(3)(B). Acquisition indebtedness is defined as:

(B) Acquisition indebtedness

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(i) In general

The term "acquisition indebtedness" means any indebtedness which--

(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and

(II) is secured by such residence.

Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

Note that we face two key requirements—the debt must be secured by this home (not some other home) and the proceeds must have been used for acquiring, constructing, or substantially improving the residence in question.

This means that if you have a client who kept taking “tax free money” out of his home as prices skyrocketed through the middle of this decade, the provision will not help if the client now discovers that the flow of cash has dried up and that the client is now unable to service that home equity debt—and faces a lender that is looking to be repaid. Rather, such a client will have to look elsewhere for relief.

Example 8: Jim and Mary purchased their residence in 1962 for \$40,000. Over the years it appreciated greatly in value, rising in value to \$2,000,000 in 2006 at which time they decided that they should “take advantage” of that increase in value in the home.

Jim and Mary borrowed \$1,500,000 with an interest only loan that was recourse. The house was at all times used as their principal residence while they owned it. Unfortunately, tough time befell Jim and they were unable to make the necessary payments on the loan and due to the decrease in real estate prices found the house was now worth less than the outstanding mortgage balance. In June of 2008 their house was foreclosed upon by the lender when the house was worth \$750,000.

Jim and Mary have a gain on sale of the home of \$710,000, which represents the \$750,000 proceeds less the \$40,000 basis in the home. Of that gain, \$500,000 can be excluded from income under §121. Note that even if Jim and Mary are

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insolvent at this point, they will not escape taxation on the \$210,000 remaining gain, though it is subject to tax at the lower long term capital gain rates.

The remaining \$750,000 will be considered cancellation of indebtedness income if the lender does not pursue collection. To the extent that Jim and Mary are not insolvent after the cancellation of the debt, they will have to treat that portion of the discharge as ordinary income. Note that they must consider assets that are not reachable in bankruptcy in determining if they are insolvent. In such a case, they might need to instead go through a formal bankruptcy to discharge the debt in order to exclude the cancelled debt from income.

The \$2,000,000 limitation is one that will be hit less often—the key issue to remember is that even though debt might not qualify as acquisition indebtedness for purposes of the home mortgage interest deduction, it may nevertheless qualify for relief under this provision. This is an issue that likely to come up far more frequently in high cost areas (including a large part of California) where million dollar homes were not at all unusual.

Relief Not Related to Financial Condition of Homeowner

The final requirement is an anti-abuse provision—taxpayers that attempt to disguise a payment for services by structuring a transaction as a relief of acquisition debt (that is paying for part of the service provider's home) won't be able to obtain this relief. The provision also allows the IRS to disallow the exclusion if the relief is given to the borrower for any reason other than their financial condition.

Non-recourse Debt

As noted earlier, if the debt involved is nonrecourse, then this provision is not applicable, as we have a sale and have to look to both the standard rules for gain or loss on sale, as well as a potential for a §121 exclusion if the sale transaction would result in again.

1. Qualified Real Property Indebtedness

A second special exemption is given for certain real property indebtedness for taxpayers other than C corporations. The exclusion exists at §108(a)(1)(D), with the definition of qualified real property indebtedness found at §108(c)(3).

To qualify for this treatment, the debt must meet the following conditions

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- Incurred with and secured by the property used in the trade or business
- It was either
 - Incurred before 1993 or
 - The debt was “qualified acquisition indebtedness” or used to refinance debt incurred before 1993 (but then only to the extent of the outstanding balance of that debt on the date it was refinanced)
- The taxpayer elects to have this provision apply to the debt by filing a Form 982 and indicating that you will be using this election. The election must be made on a timely filed return for the year in question. The election is eligible for an automatic maximum of six month extension of the election under Regulation §301.9001-2 if you file before the extended due date of the return.

Qualified acquisition indebtedness is either debt that was incurred or assumed to acquire, construct, reconstruct or substantially improve the real property that secures the debt or resulted from the refinancing of such debt, again limited to the balance of the qualified acquisition indebtedness on the first debt at the date of refinancing.

If the exclusions for either a bankruptcy cancellation or an insolvency cancellation also apply, they must be applied first before applying this provision.

The total amount that can be excluded under this provision is limited to the excess of the outstanding principal balance of the note prior to the cancellation over the fair market value of the property in question. As well, it cannot exceed the adjusted basis of depreciable real property held before the cancellation after applying any other attribute reductions under IRC §108(b) and (g).

A taxpayer excluding income under this provision must reduce the basis of the real property by the amount of debt cancellation excluded from income. If the property is disposed of prior to the end of the year of cancellation (such as if the property is foreclosed upon), its basis must be reduced prior to calculating the gain or loss on disposition of the property.

I. REPOSSESSION OF PROPERTY PREVIOUSLY SOLD ON INSTALLMENT BASIS

On the other side of the transaction, we may be representing clients who end up taking back property they had previously sold on the installment basis. When the seller reacquires the property, no loss can be recognized and gain to be recognized is

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limited. These computations are governed by §1038.

A. Other Than a Principal Residence Where §121 Came Into Play

Gain to be recognized on the repossession of property is limited to the lesser of:

- The amount of money and other property received from the buyer prior to repossession, reduced by the amount of gain previously reported as income in prior year *or*
- The original gain on the property reduced by:
 - Gain recognized in years prior to the year of possession added to
 - The amount of money and fair value of any property paid by the seller in connection with the reacquisition of the property (such as legal fees paid to reclaim the property)

Example 9: Denise sold a piece of land to April in 2005. The original sales price was \$1,000,000 and Denise had a basis of \$500,000, resulting in a gross profit percentage of 50%. Prior to 2008, Denise had collected \$100,000 on the note, and had reported \$50,000 of gain. In 2008, after the property declined in value to \$400,000, she repossessed the property and received no additional principal in the year of sale. She paid legal fees of \$10,000 in order to take back the property.

Denise's gain on repossession is \$50,000, which represents the total she collected in principal on the note (\$100,000) reduced by the gain previously recognized.

That number is lower than under the alternative calculation, where the total gain from the transaction was \$500,000, reduced by the prior gain recognized (\$50,000) and the expenses paid by Denise to reacquire the property (\$10,000), resulting in a remaining gain of \$490,000.

The basis of the property reacquired is the basis of the debt prior to repossession increased by any gain recognized on repossession and the seller's repossession costs.

Example 10: In example 9, Denise's new basis would be her basis in note (\$900,000 face value less \$450,000 unrecognized gain, or \$450,000), increased by the \$50,000 gain recognized (jumping the basis to \$500,000) and increased by her costs of repossession (\$10,000) for a new basis of \$510,000.

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A. Property Where Gain Was Excluded Under Section 121

If the seller repossesses property on which a gain was excluded under Section 121 and the seller disposes of that property within one year of the date it was reacquired, the combined sale is treated as part of the original sale transaction for purposes of applying §121 and the above rules do not apply.

Example 11: Maria sold her old residence to Mark in 2004 for \$250,000. She had a basis of \$100,000 in the residence at the time and she qualified to exclude the entire \$150,000 gain under Section 121. Mark was unable to qualify for a mortgage at the time, so Maria carried the entire balance of the sales price as an installment sale. By the beginning of 2008 she had collected \$5,000 in principal in addition to the interest on the note.

Mark defaulted on the note, and on June 30, 2008 Maria took back the property. As she already has another residence, she does not move back into her old home but rather puts it back on the market. She then sold the property for \$250,000 on November 15, 2008. For purposes of Section 121, Maria is treated as having sold the property for \$255,000 and we look back to her use and ownership status as of the 2004 sales date to determine if she qualifies for Section 121 exclusion, which she does.

If the property is not disposed of within that one year period, the standard rules noted above would apply.

Example 12: The same facts as above except that Maria is unable to dispose of the property until July 15, 2009, again for \$250,000. In this case she is not able to “look back” to 2004 and combine the sales. Rather, she first computes her basis in the property she took back by taking on the basis in note (\$245,000 face value). When she sells the property for \$250,000, she has a \$5,000 long term capital gain that will be taxable, as she does not meet the 2 year use test of Section 121 at this time.