


Debt



FORECLOSURE, SHORT SALE | AND CANCELLATION OF DEBT

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he mortgage crisis across our nation is causing record numbers of foreclosures, short sales, and debt cancellations. In the past these transactions were not very common. Now, many preparers are preparing returns reflecting these transactions for the first time. This article is not meant to be comprehensive but rather a quick guide for the preparation of tax returns involving these issues.

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First, we must understand the difference between a regular sale of real estate, a short sale, and a foreclosure. In the case of a regular or normal sale of real estate, the buyer pays enough for the property to pay any closing costs, commissions, loan taxes, and other amounts the seller owes upon the sale of the real estate. In the case of a short sale, the buyer does not pay enough to cover all these costs, and as a result the loan or loans on the property are not paid in full. In a foreclosure, the homeowner relinquishes title of the property to another interested party, generally the bank that holds the first mortgage or deed of trust on the property. Homeowner's associations, taxing agencies, and other interested parties will sometimes also foreclose on a property. In the case of a foreclosure, the mortgage(s) is usually not paid in full either.

When mortgages are not paid in full upon the transfer of real estate, as is the case in foreclosures and short sales, it can be confusing to calculate the tax implications. The key to doing this successfully is to remember that this is actually two tax transactions: a sale of real estate and a possible forgiveness of debt. The sale of real estate may or may not generate a capital gains tax, while the forgiveness of debt may or may not generate taxable ordinary income. We

straightforward. When there is a possible cancellation of debt, these figures will require some work to determine. To determine the sales price in a traditional sale, there is a final settlement statement that will provide the sales price as well as any figures from selling costs that can be used to reduce basis. However, in the case of a sale where the debt is not paid in full, the sales price will depend on the type of loan, the loan balance, and, in foreclosures the fair market value of the property.

The loan types to consider are whether the loan is recourse or non-recourse. The loan type is indicated on Form 1099A (Acquisition or Abandonment of Secured Property) in Box 5, but is not required to be indicated on Form 1099-C (Cancellation of Debt). Both of these documents are issued by the mortgage company; however, if the abandonment of the property and the subsequent cancellation of debt occur in the same year, the lender is only required to file a 1099-C. Thus, you will have to do some research to determine whether the loan was recourse or not in this instance. Furthermore, the lender may check the box that the loan was recourse in error. Recourse means the borrower is personally legally liable for the balance of the loan, and nonrecourse means after the foreclosure the borrower is free of the loan. The nature of the loan's origin will help determine whether the loan is recourse or

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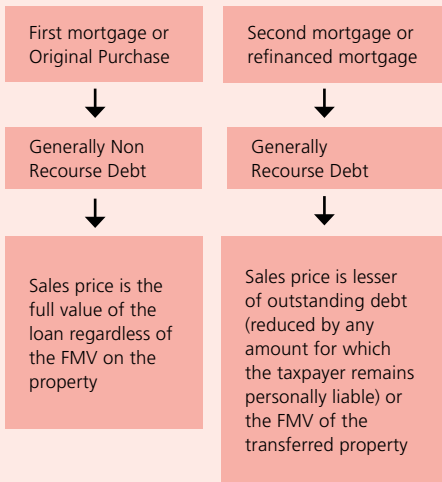
will explore further in this article more detail in regard to capital gains and taxable income resulting from the discharge of indebtedness.

Calculating the capital gains on the real estate transaction is essentially the same whether the sale pays the loans in full or not. In all cases, capital gains is the extent to which the sales price exceeds the adjusted basis of the property. In transactions without forgiveness of debt, the two key figures—sales price and adjusted basis of the property—are fairly

not. First mortgages for purchases of homes are more likely to be nonrecourse, while second mortgages and refinances are more likely to be recourse. Laws vary by state, so check your local laws for this information. A list of recourse and nonrecourse states can be found at www.mortgagereliefformula.com/recourse. This is a guide only, but will help you start with what might be the conditions in your state.

There will be a final settlement statement in the case of a short sale. However, in a short

FIG. 1 Foreclosure



Short Sale

Recourse Debt: Actual price paid by the buyer. Selling expenses are still used to reduce any potential gains (or increase losses in the case of business property).

Nonrecourse Debt: The outstanding balance of the loan.

sale, the sales price for capital gains purposes will be the amount stated as gross proceeds on the sale only if the loan is recourse. If the debt is nonrecourse, the sales price is the balance of the loan. When the transfer (sale) is a foreclosure, the sales price will be either the fair market value (FMV) of the property or the amount of the outstanding mortgage. If the mortgage is nonrecourse, the sales price is the full value of the loan, regardless of the FMV of the property. If the debt is recourse, the sales price is the lesser of the outstanding debt immediately before the transfer reduced by any amount for which the seller remains personally liable after the transfer or the FMV of the transferred property. FMV is established, per the instructions for forms 1099-A and 1099-C, as “generally the gross foreclosure bid price. If an abandonment or voluntary conveyance to the lender in lieu of foreclosure occurred, enter the appraised value of the property.”

If the cancelled debt is nonrecourse, there is no debt discharge income recognized by the borrower as the borrower is not liable to repay any amounts above what is satisfied by the sale. However, if it is recourse debt, to the extent that the loan exceeds the FMV of the property, there is income if the bank forgives the remaining debt. The lender may add to the discharged debt the amount of accrued interest (be sure to check on this, as the accrued interest, if included as income, can also be

deducted on Schedule A). Any administrative costs charged by the lender would be added to the basis of the property.

Once the sales price is determined, you can determine the gain or loss. If the real estate was a primary residence that qualifies for the exclusion of gain under Sec. 121, that

exclusion will still apply against the capital gains on a foreclosure or short sale. If the taxpayer does not meet the requirements for a full exclusion, do not forget to review the possibility of a reduced exclusion. Under the safe harbors for unforeseen circumstances, involuntary conversion, loss of job, and change in employment are all listed as circumstances that qualify for using the reduced exclusion rules.

If the property was investment property, any capital gains or losses receive the same treatment in these circumstances as they would under normal circumstances. Do not forget to determine if there is any depreciation recapture to consider or if there are any suspended losses due to passive activity loss limitations that need to be released. This is particularly important for first-year clients who may have been preparing their own returns or using a less qualified preparer.

Once the gain or loss on the sale has been determined, we must look at whether or not there is income resulting from the cancellation of debt. The 1099-C issued by the bank or mortgage company provides the amount of

FIG. 2 Determining Taxability of Capital Gains:

Sale Price of Home: _____
(See Fig.1 for assistance)

Basis (add the following): _____

Purchase Price of Home: _____

Closing costs incurred at purchase not previously deducted: _____
Include escrow and title fees, recording fees, transfer taxes, etc. DO NOT INCLUDE points, impound funding, insurance, property taxes, or interest.

Improvements: _____
Include anything that stays with the house and has a life expectancy greater than one year such as landscaping, window treatments, remodeling, roofs, windows, pools, additions, concrete work, built-in appliances, cabinets, garage door openers, flooring, etc.

Depreciation allowed or allowable
(enter as a negative number): _____

Reductions to basis for discharged indebtedness excluded from income if applicable (from Form 982, Line 10B and enter as a negative number) _____

Selling Costs (add the following): _____

Closing Costs: _____
Include charges not deducted elsewhere from the closing statement such as escrow fees, title insurance, commissions, recording charges, transfer taxes, etc. DO NOT INCLUDE loan payoffs, interest, property taxes, or related expenses.

Fix-up costs: _____
Any costs incurred by the seller in the ninety days prior to sale to ready the home for sale such as painting, planting flowers, steam cleaning carpets, etc.

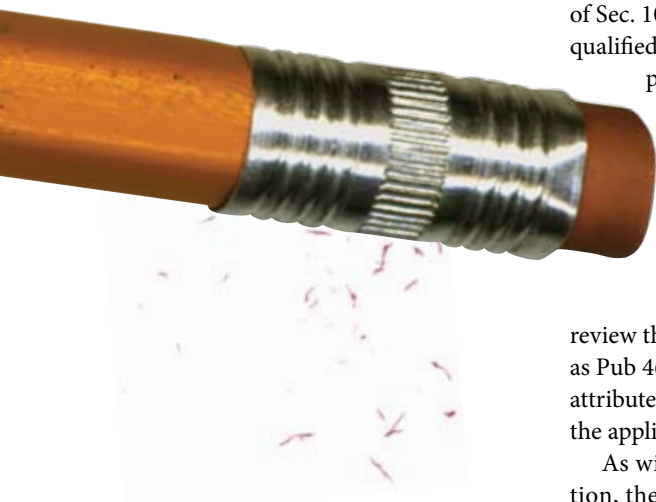
Capital Gain<loss>:
Sales price – Basis – Selling costs _____

If positive: Was this home a qualified personal residence that qualifies for a full or partial exclusion under Sec. 121? If not, the gain is all taxable, even if the seller did not receive any cash.

If negative: Was this real property used in a business, such as a rental property? If yes, then the loss can be deducted as a capital loss. Otherwise, this loss has no tax benefits.

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debt that has been discharged. The cancellation of debt will become taxable ordinary income unless the taxpayer qualifies for one of the exemptions under Sec. 108. Generally, if you exclude cancelled debt from income under one of the provisions of Sec. 108, you must also reduce your tax attributes such as basis, credits, and losses. The exemptions of Sec. 108 include bankruptcy, insolvency, qualified farm indebtedness, qualified real property business indebtedness, and qualified principal residence indebtedness. To claim any of these exclusions, complete Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness) and include it with the tax return.

It will be very helpful to carefully review the instructions for this form as well as Pub 4681 to determine the reduction of tax attributes. There are strict ordering rules as to the application of these reductions.

As with any complicated tax transaction, there are aspects of foreclosure and short sales that can be difficult to explain to clients. Any taxpayer who ends up paying

taxes on a foreclosure or short sale will have a difficult time understanding why. One reason that will likely be seen often is when the taxpayer does not qualify for any of the cancelled debt exclusions.

The newest Sec. 108 exclusion for qualified principal residence indebtedness comes with a catch: debt forgiveness is only granted on purchase debt or refinanced purchase debt to the extent it is the same as the purchase price of the property. Many homeowners took advantage of rising real estate values and took equity out of their homes. When these loans go into foreclosure, the sales price of the home may actually exceed the purchase price without covering the debt. This could result in taxable income unless the taxpayer qualifies under another provision. If you have a client who is facing foreclosure or short sale, it is advisable to review the taxpayer's circumstances just prior to the cancellation of debt to determine if there is any relief available to them through the insolvency exemption. In some cases your client may be considering other financial options such as bankruptcy, so a review of the tax consequences of the

FIG. 3: Calculating Taxpayer Solvency

(All figures should be as of the moment before discharge of indebtedness)

Assets:

Cash (include actual cash and money in bank accounts) _____

Investment Accounts (include retirement and non-retirement accounts, individual stocks and bonds, mutual funds, etc.) _____

Cash surrender value of life insurance policies _____

FMV of real estate owned, including surrendered real estate _____

FMV of autos, trucks, boats, RVs, trailers, motorcycles, etc. _____

FMV of household items including furniture, appliances, clothing, tools, computers, jewelry, art, collectibles, electronics, etc. _____

Any money owed to taxpayer as part of a settlement, loan repayment, refund, inheritance, or any other source: _____

Total Assets _____

Liabilities:

Taxes Due _____

Loans on retirement accounts due _____

Mortgages _____

Credit Card balances _____

Loans on vehicles _____

Lines of credit and other loans due _____

Total Liabilities: _____

Net Worth: Total Assets _____

- Total Liabilities _____

= Net Worth _____

If net worth is negative, the taxpayer is insolvent to the extent that the discharged debt, when subtracted from the liabilities, will still yield a negative net worth. Example: Net worth is <\$40,000.> Cancelled debt is \$50,000. The taxpayer may exclude from income \$40,000 – the extent to which the cancelled debt is equal to or less than the negative net worth of the taxpayer.

different types of bankruptcy may be important advice for your client and his or her bankruptcy attorney.

Be careful if your client wishes to convert the property to rental property prior to foreclosure in an effort to be able to claim the loss on the property. Unfortunately, this will not work as Final Regulation Sec. 1.165-9 states that the basis that is used to determine loss is the lesser of the FMV at conversion or the adjusted basis for loss determined under Sec. 1.1011-1. In short, this means that unless the property did not lose value until after the conversion to rental property, there will not be any loss to deduct.

Timing issues may also be a factor to consider. In many cases the action of foreclosure will cross calendar years and thus cross tax

years. The date of sale is normally construed to be the date of the foreclosure auction or the date of known abandonment if that occurs significantly in advance of the foreclosure. According to the directions on the 1099-C and 1099-A, if the transfer of ownership happens within three months of the abandonment, then the reporting date is the date of abandonment. If this is not the case, the reporting date is three months after the abandonment date. Any rights of redemption days must be added to the auction date to calculate the date of sale.

Another challenge may be in determining the fair market value of the property. Relevant in the case of a recourse loan, the fair market value on the date of transfer may be higher than the value reported in Box 7 of the 1099-C. The argument would be with the lender, not

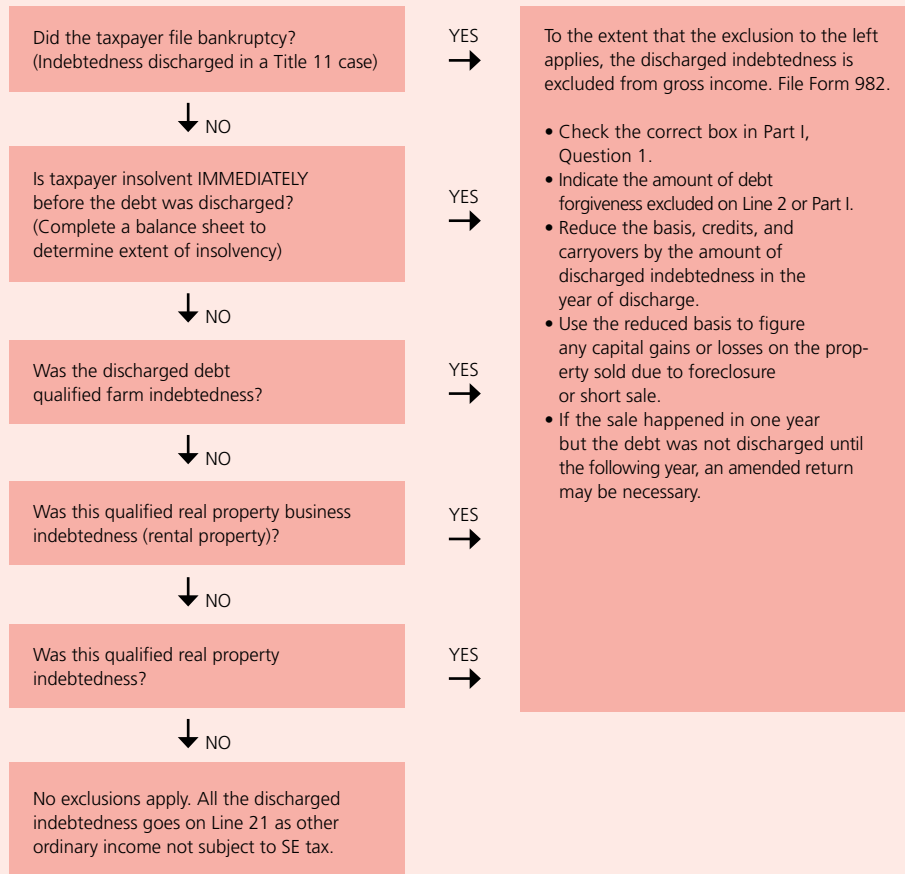
the IRS, as the IRS will go with what the lender reports. It may be advisable for the client to obtain an appraisal or other qualified opinion as to the value of the property on the date of transfer and use this information to ask the lender for a corrected 1099-C.

The IRS has created a new publication regarding cancellation of indebtedness. Pub 4681 is twenty pages full of explanation, examples, and sample completed forms. This is a “must read” for anyone in an area with high foreclosure activity.

The number of foreclosures and short sales in 2008 is astounding. According to foreclosureS.com, over 900,000 completed foreclosures are expected in 2008 with about one-third of them located in just ten counties nationwide. As enrolled agents, we are uniquely qualified to assist taxpayers with determining their options in regard to surrender of real estate and to prepare the returns that result from such. We, as the tax professionals, are the most tax education focused in the general tax preparer community. Taxpayers dealing with cancellation of indebtedness who try to self-prepare their returns or go to an unqualified preparer are likely to find themselves facing CP2000 letters proposing an increase in taxes. Getting the matter straightened out with the IRS is likely to cost the taxpayer far more than having his or her tax return prepared by an enrolled agent now. Do not forget to include this in your marketing efforts this upcoming tax season.

Cancellation of debt income is likely to be common for a number of years as our country goes through extreme economic turmoil. At first glance, handling this type of income on a tax return, specifically as related to real estate, can seem difficult and complicated. If you remember to break down the transaction into the individual parts, you will easily be able to handle whatever your clients may throw at you. **EA**

FIG. 4: Cancellation of Debt: Is it Taxable?



About the author:

Laura Strombom, EA, MBA became an enrolled agent in 2001. She is the founder and majority shareholder of All About Numbers, Inc., located in Stockton, CA. Laura and her team prepare over 3000 returns each year, giving them a wide cross section of returns from which to draw experience. When not preparing taxes, Laura is most likely to be found on the back of a horse.