

TAX CONSEQUENCES OF FORECLOSURE AND SHORT SALES

The meltdown in real estate values in recent years has led to numerous debtor defaults and to creditors' lowering the carrying values of mortgages. This renegotiation of mortgage balances, transacting in short sales, and losing property to foreclosures creates two basic income tax problems:

- 1) There is cancellation of debt (COD) income.
- 2) There is gain or loss on the sale or exchange of real estate.

Gross income includes income from the discharge of indebtedness 61(a)(12). However under 108(a) of the codes there are five ways to exclude COD income from gross income as follows:

- 1) The discharge occurs in a title 11 bankruptcy case
- 2) The discharge occurs when the taxpayer is insolvent
- 3) The indebtedness discharged is qualified farm indebtedness
- 4) In the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or
- 5) The indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013. However, there are different tax consequences when the discharge of indebtedness is qualified principal residence indebtedness discharged between 1/1/2007 and 1/1/2013 on recourse versus nonrecourse loans.

Since most of the foreclosures and short sales involve principal residences, we will focus on the fifth way to exclude COD income. The fifth way excludes from gross income qualified principal residence indebtedness discharged after 2006 and before 1/1/2013. Qualified principal residence indebtedness is "acquisition indebtedness", except that the total indebtedness excluded is \$2 million. Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence and is secured by the residence. The term also includes refinancing indebtedness as long as the refinanced loan does not exceed the original indebtedness. However, if the refinanced indebtedness in excess of the original acquisition indebtedness is used to substantially improve the principal residence, it will also be considered acquisition indebtedness. The above definition of acquisition indebtedness excludes home equity indebtedness unless the taxpayer uses the equity debt to make improvement to the principal residence. So, absent one of the above five ways to exclude COD income, the COD income will result in income recognition.

The definition of principal residence is the same as Section 121. Section 121 provides that for a residence to qualify as a principal residence, the taxpayer must own and use the residence for two of the five years preceding the sale by the taxpayer. The ownership and use tests need not be concurrent. The exclusion is limited to \$250,000 in the case of an individual and \$500,000 in the case of a married couple filing jointly. Section 121 provides

that for a married couple, both spouses must meet the use requirement but only one spouse must meet the ownership requirement.

When a creditor reduces a loan balance on the principal residence, Section 108 provides that the basis of the residence shall be reduced (but not below zero) by the amount of the discharge. However, Section 108 states that the general rule of nontaxability will not apply if the reason for the discharge is services performed by the debtor for the lender or any other factor not related to the decline of the property's value or the taxpayer's financial condition.

Further, under Section 108 the general exclusion rule on principal residence indebtedness discharge will not apply if the discharge occurs in a title 11 bankruptcy case. Rather, the exclusion for debt discharged in bankruptcy will take precedence. However the principal residence exclusion rule will take precedence over the insolvency exclusion unless the taxpayer elects otherwise. A taxpayer who uses any of the income exclusion provisions under Section 108 must file with the tax return Form 982, Reduction of Tax Attributes due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).

As mentioned before, the total amount of principal residence indebtedness that qualifies for relief is \$2 million. However, there will be no limit on the amount of relief if the debt is a purchase money mortgage. This means that the property's seller is carrying the mortgage. This is not an unusual occurrence for very large mortgages where a third party may not be willing to extend credit. Debtors who have purchase money mortgages simply reduce their basis in the property by the amount of the indebtedness discharge. It should be emphasized that the provisions of purchase money debt reduction apply to all property, not only principal residences. However, the exclusion will not apply in a title 11 case or when the purchaser is insolvent. Since the balance of acquisition indebtedness is almost always less than the tax basis of the residence, it would be highly unusual for there to be a gain from a foreclosure.

RECOURSE AND NONRECOURSE DEBT

The tax consequences of principal residence acquisition indebtedness discharge can have differing impacts depending upon whether the debt is recourse or nonrecourse. Recourse debt means that the debtor can be held personally liable in the event of default. Thus, if the FMV of the property that secures a loan is not sufficient to cover the outstanding principal of the loan in the event of default, a creditor can attach other property owned by the debtor to cover the loan balance. Nonrecourse debt means that the creditor can seize only the property that secures the loan, even if the FMV of that property is not sufficient to cover the loan balance. For example, principal residences are sold in California on a nonrecourse basis. Hence, homeowners can walk away from their loans without fear of being pursued by the creditors. . The regulations provide that relief of a nonrecourse loan will be sufficient consideration received for property that is in default. However mortgages from refinancing a previous mortgage are usually recourse

Example 1: Taxpayer T defaults on a nonrecourse mortgage loan of \$300,000. The principal residence basis is \$320,000, and the FMV is \$250,000. The property is considered to be sold for \$300,000, and its FMV is irrelevant for purposes of determining liability relief. T has an unrecognized \$20,000 loss because the property is personal use property. However, there are no further tax consequences as a result of the default.

The taxpayer can simply walk away from the loan. The lender issues the taxpayer Form 1099-A, Acquisition or Abandonment of Secured Property. The taxpayer does not file a Form 982 because there has been no discharge of indebtedness. The taxpayer reports the sale on a Form 1040, Schedule D, Capital Gains and Losses. Since a loss cannot be recognized, the sales price (\$300,000 and the property's basis (\$320,000) will both show as \$300,000.

However, if the nonrecourse lender cancels part of the debt for \$600 or more under the repossession (e.g., a lender cancels part of the debt and then later in the year forecloses), the lender must file Form 1099-C, Cancellation of Debt. The taxpayer files Form 982 and Schedule D.

In the above example, if the lender has recourse against the taxpayer for property other than the property securing the loan, the treatment changes. The borrower automatically has discharge of indebtedness income of \$50,000, the difference between the property's FMV (\$250,000) and the loan balance on the property (\$300,000). The property is then considered sold for the remaining \$250,000 debt securing the property. This results in a \$70,000 loss that the taxpayer cannot recognize for tax purposes because the principal residence is personal use property. However, the taxpayer is allowed to treat the indebtedness discharge under the general rule of indebtedness discharges for qualified principal residence indebtedness. The taxpayer files Form 982 showing the amount of the discharge excluded from income and also files Form 1040, Schedule D, showing a sale for \$250,000 and a basis of \$250,000 (since the loss is non-deductible the basis of \$320,000 is reduced).

Many recourse lenders are allowing taxpayers to sell their principal residences in what is referred to as a short sale.

Example 2: Taxpayer V sells her principal residence property for less than the mortgage that secures it. The lender issues Form 1099-C to V. Box 5 on the form asks whether the taxpayer is personally liable (recourse liability). If V is personally liable, she either must recognize income from the discharge of indebtedness or is allowed the exclusion from the discharge if the requirements of a discharge of qualified principal residence indebtedness are met.

In the above two examples there are no differences for tax purposes between the nonrecourse and recourse notes securing the property. The only difference is how the transactions are reported when the taxpayer loses the principal residence.

What if the discharged debt exceeds \$2 million?

Example 3: Taxpayer W has a basis in her principal residence of \$9 million, a FMV of \$5 million, and a loan balance of \$8 million. W defaults, and the property is repossessed by the lender. There are no tax consequences if this is a nonrecourse mortgage; it is simply treated as a sale of the property for \$8 million.

However, if the note is recourse and the lender allows W to enter into a short sale, she will have \$3 million of discharge of indebtedness income, the difference between the mortgage on the property and its FMV. W has \$3 million of income recognition, since there is 6,000,000 of non-qualified principal residence indebtedness (\$8,000,000 - \$2,000,000), which is greater than the COD income. Only if the COD income is greater than the non-qualified principal residence debt can the balance become qualified principal residence indebtedness subject to income exclusion and basis reduction. The remaining \$5 million is treated as consideration paid for the property. The basis of the property is \$9 million, leaving W with an unrecognized loss of \$4 million (\$5 million remaining loan less \$9 million remaining basis).

Complications also arise if the taxpayer has borrowed against the increased value of the property during times when real estate values were high. Equity borrowing was quite common before the real estate meltdown. The relief afforded under discharge of qualified principal residence indebtedness does not apply to equity borrowing.

Example 4: Taxpayer X has a nonrecourse acquisition note and a nonrecourse equity note on his property. The equity loan proceeds are not used for improvements to the principal residence. X's basis is \$500,000 (original acquisition cost), FMV is \$350,000, principal acquisition residence indebtedness is \$450,000, and equity debt is \$150,000. Third-party holders of the debts cancel \$50,000 of the acquisition indebtedness and \$100,000 of the equity debt. X keeps the home and recognizes \$100,000 discharge of indebtedness income on the equity debt.

Each debt discharge will be reported to X on a Form 1099-C. However, X can exclude the \$50,000 of acquisition indebtedness under the general rule. In this example, the results are the same if the debt is recourse because X has not disposed of the principal residence.

However, the results change if the taxpayer gives up the principal residence either through foreclosure (nonrecourse mortgage) or a short sale (recourse mortgage). If both loans are nonrecourse and the creditors foreclose, he will have \$100,000 of capital gain (\$600,000 of debt relief on a principal residence with a basis of \$500,000) If he meets the criteria of Section 121 for exclusion of gain on the sale of a principal residence, he

will not have to recognize any of the gain. Even if he must recognize the gain, the taxpayer has the advantage of the long-term capital gain rates instead of the ordinary income rates on \$100,000 that he would have to recognize as discharge of indebtedness income if he keeps the principal residence.

If the debts are recourse, the taxpayer will not have the benefit of capital gain recognition and Section 121 exclusion. If the creditors allow him to engage in a short sale for \$350,000, the home's FMV, he will have \$150,000 of ordinary income on the equity debt discharge and \$100,000 ordinary income on the acquisition debt discharge. He will be allowed the benefit of the exclusion for qualified principal residence indebtedness only on the \$100,000 of acquisition debt. Thus, if the debts are nonrecourse, the taxpayer has \$100,000 of capital gain potentially eligible for the Section 121 exclusion. If they are recourse, there is \$250,000 of ordinary income of which the taxpayer can exclude only \$100,000 from recognition.

PLANNING OPPORTUNITIES

As the above examples show, there are far more planning opportunities with nonrecourse as opposed to recourse mortgages. In some instances with a nonrecourse mortgage, the tax consequences of default can be more favorable than the consequences of keeping the home. This is true when there are nonrecourse equity loans involved, when keeping the property produces ordinary income and conversion of the property produces capital gains which might be excluded under 121.

Example 5: Taxpayer Y purchases a house for \$550,000. At present, there is no acquisition indebtedness. Y borrows \$500,000 on the house's equity when it is worth \$650,000. The house's present value is \$400,000. If the nonrecourse equity lender agrees to discharge \$100,000 of the loan so that Y will owe only the house's FMV, there will be \$100,000 of discharge of indebtedness income. However, there are no tax consequences if Y defaults and the house is repossessed. Y is considered to have sold the house with a tax basis of \$550,000 for the amount of the \$500,000 debt relief.

If the debt is recourse and there is a short sale for \$400,000, there will be \$100,000 of ordinary income and a \$150,000 loss that cannot be recognized for tax purposes (\$550,000 basis less \$400,000 sales price)

There can be no discharge of qualified principal residence relief since there is no principal residence acquisition indebtedness remaining on the loan. Hence, with nonrecourse mortgages it may be advantageous for tax purposes to simply walk away from the house and allow the lender to repossess it.

CONCLUSION

The exceptions to income recognition for discharge of indebtedness income for a principal residence can have differing tax impacts depending upon whether the debt is nonrecourse or recourse. Obviously, there are situations in which a taxpayer will be in a more advantageous position when the debt is nonrecourse, because the property's FMV fluctuations will not affect the tax considerations in the event of a default. The total debt, both acquisition and equity, will be treated as consideration for the sale. However, the taxpayer will have discharge of indebtedness income on equity debt relief when the loan is recourse and the lender allows a short sale. In this instance, any loss on the sale cannot be used to offset the income because the principal residence is personal use property.

When the taxpayer keeps the principal residence, the discharge will have the same impact for nonrecourse and recourse debt. In both instances, the taxpayer can reduce the basis of the principal residence by up to \$2 million or the beginning basis amount of the discharge for acquisition indebtedness. In both instances, the taxpayer will also have to recognize income from any discharge of equity debt.