Ten More Myths About the Tax Consequences of Foreclosures and Short Sales

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In the January 2009 and August 2009 issues of the *California Enrolled Agent*, I discussed the income tax consequences of foreclosures and short sales involving a principal residence and rental property, respectively, and in the November 2010 issue, I debunked ten of the "myths" about the tax consequences that have been spread by other tax practitioners. In the May/June 2011 issue, I discussed the reduction of "tax attributes" that's required when a taxpayer excludes cancellation of debt income (COD income) using the bankruptcy or insolvency exclusions. There's still a great deal of confusion about how the law applies to these transactions. In this article, I hope to clear up ten more "myths."

Background

One of the first questions to be answered in determining the income tax consequences of a foreclosure or short sale is to determine if the debt is nonrecourse or recourse. A debt is **nonrecourse** if the lender can't hold the borrower personally liable for it and may go only against the value of the property to collect. A debt is **recourse** if the lender can hold the borrower personally liable for it beyond the value of the property.

The importance of this distinction is that where title to the property is transferred, such as in a foreclosure or short sale, if the debt is **nonrecourse**, then there is no COD income. Instead, the principal amount of the debt is treated as the "amount realized" in computing gain or loss.[1] But if the debt is **recourse**, then the transaction is split into two parts: (1) COD income equal to the principal amount of the debt minus the fair market value (FMV) of the property, and (2) gain or loss equal to the FMV of the property minus its adjusted basis.[2]

Myth #1 – The amount of COD income in a foreclosure and short sale are the same.

Many tax practitioners have written to me about the amount of COD income reported on a Form 1099-C. They want to dispute the amount of COD income shown on this form because it's more than the principal amount of the debt minus the FMV of the property. Is this a valid dispute?

Probably not. In a short sale, the lender applies the net proceeds of the sale against the balance of the debt and cancels the remainder. In such a case, the principal amount of debt canceled is the amount of COD income. This is higher than in a foreclosure, and the difference is the selling expenses of the short sale (realtor commissions, title insurance, escrow fee, recording fees, etc.) that are deducted from the gross sales price.

In the only Tax Court case I'm aware of that involved a short sale, the Tax Court concluded that the amount of COD income was the amount reported on Form 1099-C.[3]

Myth #2 – Where there's a first and second mortgage, and the lender holding the first mortgage forecloses, the second mortgage isn't canceled.

It depends.

Assume that the taxpayer purchased a principal residence and financed the purchase with an 80 percent first mortgage loan and a 20 percent second mortgage loan. Suppose further that both loans were nonrecourse because the taxpayer obtained the loans to purchase the property.[4] When the lender holding the first mortgage loan forecloses, is the second mortgage canceled? Yes, because in the case of a nonrecourse loan, the lender's only recourse is to the property. If the lender holding the first mortgage forecloses and acquires the property, there's nothing for the holder of the second mortgage loan to collect from, so it's deemed canceled.

Assume the same facts, except that both loans are recourse. In that case, at least in California, it depends upon who holds the loans. In California, if the same lender holds both the first and second mortgage loans and forecloses using the non-judicial foreclosure procedure by exercising its rights under the deed of trust for the first mortgage loan (notice of default, period of redemption, trustee's sale), the second mortgage loan is deemed canceled.[5] If a different lender holds the second mortgage loan, then that lender may pursue the borrower for payment.

Myth #3 – Where two or more people are joint obligors on a debt that's canceled, each must report their share of the COD income.

Not necessarily.

When a loan has several co-signers, then all co-signers are jointly and severally liable for the loan. If a part of the loan is subsequently canceled, then it's likely that the lender will issue a Form 1099-C to **each** of the co-signers showing the **full amount** of the debt that was canceled. If there are three co-signers, then each will probably receive a Form 1099-C showing the full amount (not one-third) of such income.

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In Chief Counsel Advice, the IRS advised that in the case of such co-signers, based on the facts and circumstances, a determination should be made as to which of the co-signers should report the income or how such income should be allocated among them.[6]

For example, suppose that Mom and Dad co-signed a recourse loan for their daughter so that she could purchase a principal residence, that the daughter made all of the payments on the loan, and that several years later the residence was lost to foreclosure. If the daughter occupied the residence and Mom and Dad lived elsewhere, and if Mom and Dad are allocated two-thirds of the COD income, then Mom and Dad won't be able to exclude the COD income using the principal residence exclusion of IRC §108(a)(1)(E). It would probably be better to allocate all of the COD income to the daughter in order to maximize usage of the exclusion.

Myth #4 – Since you must reduce the basis of business property by the amount of the Qualified Real Property Business Indebtedness (QRPBI) exclusion, there's no benefit in claiming the exclusion.

Wrong.

If there's COD income resulting from a foreclosure or short sale of real property used in a business (such as real property rented to tenants), and if such COD income is excludable using the QRPBI exclusion of IRC §108(a)(1)(D), in computing gain or loss on the transaction, you must reduce the basis of the property by the amount of the exclusion.[7] In most cases, this has the effect of reducing the loss or increasing the gain by the same amount as the exclusion, resulting in a "wash."

Some argue that if there's a gain, then it's better to claim the QRPBI exclusion and increase the gain because it will be treated as a capital gain under IRC §1231 (the tax rates on capital gains are lower than on ordinary income). Sorry, but Congress closed that loophole. The gain will be taxed as ordinary income to the extent of the QRPBI exclusion.[8]

If there's a loss, then claiming the QRPBI exclusion will reduce the amount of the loss. This could have an effect if the taxpayer has a section 1231 gain in the next five years. Under IRC §1231(c), section 1231 gains in a particular tax year must be recaptured as ordinary income to the extent of any "unrecaptured" section 1231 losses deducted in the preceding five years. By claiming the QRPBI exclusion and minimizing the loss, you could reduce the impact of this recapture rule in a future year. If you didn't claim the QRPBI exclusion, then you wouldn't be able to fix this problem in the future year because the QRPBI exclusion must be claimed on a timely-filed return.[9]

And lastly, the QRPBI exclusion can make a difference in the case of a personal residence that has been converted to rental use where the FMV of the property at the time of conversion is lower than original cost. See the following illustration of a short sale:

COD Income		
Principal balance of loan		$530,000
Sales price	$325,000	
Less: Selling expenses of short sale	(20,000)	
Net proceeds of short sale	$305,000	(305,000)
Amount of Debt Canceled = COD Income		$225,000
IRC §108(c)(2)(A) Limitation on QRPBI Exclusion		
Principal balance of loan		$530,000
Fair market value of property		(325,000)
IRC §108(c)(2)(A) limitation on QRPBI exclusion		$205,000
Calculation of Loss		
Sales price		$325,000
Less: Selling expenses of short sale		(20,000)
Amount Realized		$305,000
(a) Original cost of property	$550,000	
(b) FMV at time of conversion to rental use	325,000	
Lower of (a) or (b) (Treas. Reg. §1.165-9(b)(2))	$325,000	
Less: Depreciation	(15,000)	
Less: QRPBI exclusion (IRC §1017(b)(3)(F)(iii))	(205,000)	
Adjusted Basis		(105,000)
Loss on Short Sale		$200,000
Since this is a gain, there is no loss.		
Calculation of Gain		
Sales price		$325,000
Less: Selling expenses of short sale		(20,000)
Amount Realized		$305,000
Original cost of property (Treas. Reg. §1.1011-1)	$550,000	
Less: Depreciation	(15,000)	
Less: QRPBI exclusion (IRC §1017(b)(3)(F)(iii))	(205,000)	
Adjusted Basis		(330,000)
Gain on Short Sale		$(25,000)
Since this is a loss, there is no gain.		

Without claiming the QRPBI exclusion, there would be $225,000 of taxable COD income and a $5,000 loss on the short sale. By claiming the QRPBI exclusion, there's only $20,000 of taxable COD income and no gain or loss on the short sale.

Myth #5 – COD income resulting from the foreclosure or short sale of property held for investment may not be treated as investment income that increases the limitation for deducting investment interest expense.

Wrong.

Such COD income is treated as investment income.[10]

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Myth #6 – When calculating insolvency, the balance in a qualified retirement plan isn't counted as an asset because it's exempt from the claims of creditors.

Wrong.

The Tax Court has held that in determining a taxpayer's extent of insolvency for purposes of claiming the insolvency exclusion, assets that may be exempt from claims of creditors are included in the calculation.[11]

~~Furthermore, if the taxpayer is receiving benefits from a pension or annuity (including social security), the present value of those monthly benefits over the taxpayer's remaining lifetime is counted as an asset in the insolvency calculation.~~[12]

See footnote below

Myth #7 – When calculating insolvency, all liabilities that the taxpayer potentially could be liable for are counted.

Not always.

You can include contingent liabilities or liabilities that the taxpayer has guaranteed only if it is more likely than not that the taxpayer will be called upon to pay them.[13]

There's a special rule for nonrecourse debt. Where nonrecourse debt exceeds the FMV of the property, include it as a liability in the insolvency calculation, but only to the extent of the FMV of the property.[14] The reason for this is that the taxpayer won't be called upon to pay the excess.

Do not include as liabilities past-due mortgage interest or real estate taxes to the extent that these amounts would be deductible if they had been paid. IRC §108(e)(2) provides that COD income does not include the cancellation of any liability to the extent that payment of the liability would give rise to a deduction. The Tax Court has held that the same rule applies in determining a taxpayer's extent of insolvency.[15]

Myth #8 – When calculating the extent of insolvency on a joint return where only one spouse received COD income, you can either combine the assets and liabilities of the spouses or have separate calculations for each spouse.

Wrong.

Each spouse is required to determine his or her own extent of insolvency separately, even if the spouses file a joint return.[16]

Myth #9 – When the taxpayer excludes COD income relating to the foreclosure or short sale of business property by using the insolvency exclusion, in computing gain or loss, reduce the adjusted basis of the property by the insolvency exclusion.

Wrong.

I have heard that the IRS has taken this position in several audits. There is no authority for this position.

If a taxpayer qualifies for the insolvency exclusion, then the amount excluded must be used to reduce the taxpayer's "tax attributes," such as net operating loss carryovers, general business credit carryovers, minimum tax credit carryovers, capital loss carryovers, the basis of property, passive loss carryovers and foreign tax credit carryovers, in this order.[17] Except for the basis of property, these reductions are made after the taxpayer's tax liability for the year of the discharge has been determined.[18] The basis of property is reduced on the first day of the following tax year.[19] The taxpayer may elect to apply the reduction to the basis of depreciable property first, instead of in the order listed above,[20] but the reduction still occurs on the first day of the following tax year.[21]

Myth #10 – If the basis of the taxpayer's principal residence is one of the "tax attributes" that's reduced by the bankruptcy or insolvency exclusion, the subsequent gain on the disposition of that residence may be excluded under the home sale exclusion of IRC §121.

Wrong.

The reduction of basis by the bankruptcy or insolvency exclusion is treated as a deduction allowed for depreciation.[22] In determining how much of the gain on the disposition of a taxpayer's principal residence is excludable under the home sale exclusion, the portion of the gain allocable to depreciation isn't excludable.[23]

Conclusion

I hope that this article has cleared up some more of the "myths" and rumors about the income tax consequences of foreclosures and short sales. As indicated in the discussion above, analyzing the transactions and determining the income tax consequences can be quite complicated. Understanding how to apply these rules is crucial to arriving at the correct result.

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1 *Commissioner v. Tufts, 461 U.S. 300 (1983); Treas. Reg. §1.1001-2(a)(1); L&C Springs Associates et al. v. Commissioner, 188 F.3d 866 (7th Cir. 1999); Rev. Rul. 76-111, 1976-1 C.B. 214.*

2 *Frazier v. Commissioner, 111 T.C. 243 (1998); Treas. Reg. §1.1001-2(a)(2); Example (8) at Treas. Reg. §1.1001-2(c); Rev. Rul. 90-16, 1990-1 C.B. 12.*

3 *Stevens v. Commissioner, T.C. Summary Opinion 2008-61.*

4 *See section 580b of the California Code of Civil Procedure.*

5 *See Simon v. Superior Court, 4 Cal.App.4th 63 (1992).*

6 *See Chief Counsel Advice 200023001 (Feb. 4, 1999).*

7 *IRC §1017(b)(3)(F)(iii).*

8 *IRC §1017(d).*

9 *IRC §108(c)(3)(C) and Treas. Reg. §1.108-5(b).*

10 *See IRS Letter Ruling 200952018 (Sept. 17, 2009)*

11 *Carlson v. Commissioner, 116 T.C. 87 (2001).*

In *Schieber v. Commissioner*, T.C. Memo. 2017-32, the Tax Court ruled that if the taxpayer is receiving monthly pension benefits but has no immediate access to other benefits, then no amount needs to be included as an asset in the insolvency calculation.

12 *Caton v. Commissioner, T.C. Memo. 1995-80; Johns v. Commissioner, T.C. Sum. Op. 2001-67; Gale v. Commissioner, T.C. Sum. Op. 2006-152.*

13 *Merkel v. Commissioner, 192 F.3d 844 (9th Cir. 1999).*

14 *See Revenue Ruling 92-53, 1992-2 C.B. 48.*

15 *See Lawinger v. Commissioner, 103 T.C. 428 (1994), footnote 4; Merkel v. Commissioner, 109 T.C. 463 (1997), footnote 17, affirmed on another issue 192 F.3d 844 (9th Cir. 1999).*

16 *See IRS Letter Ruling 8920019 (May 19, 1989).*

17 *IRC §108(b)(2).*

18 *IRC §108(b)(4)(A).*

19 *IRC §1017(a).*

20 *IRC §108(b)(5).*

21 *IRC §1017(a)(2).*

22 *IRC §1017(d)(1).*

23 *IRC §121(d)(6).*