Reducing Tax Attributes Due to Canceled Debt Income Exclusion

By David M. Fogel, EA, CPA

In previous issues of the *California Enrolled Agent*, I've discussed the income tax consequences of foreclosures and short sales involving a principal residence and rental property, and I've debunked some of the myths that have been spread by other tax practitioners.[1] One topic about which there seems to be a lot of confusion is how and when a taxpayer's "tax attributes" must be reduced when the taxpayer excludes canceled debt income using the insolvency or bankruptcy exclusions. This article discusses these rules.

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 cancellation of debt income (COD income). Instead, the principal amount of the debt is treated as the "amount realized" in computing gain or loss.[2] 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.[3]

The Bankruptcy and Insolvency Exclusions

COD income is excludable from gross income if the debt cancellation occurs in a Title 11 (bankruptcy) case.[4] To qualify for the exclusion, the debtor must be under the jurisdiction of the bankruptcy court and the debt discharge is granted by the court or occurs as a result of a plan approved by the court.[5] The debt does not specifically have to be discharged by the bankruptcy court to be covered by the bankruptcy exclusion. The bankruptcy discharge applies to all dischargeable debts at the time it is granted.[6]

A debt is viewed as having been discharged the moment it becomes clear that it will never have to be paid.[7] As a result, in a bankruptcy case, a debt secured by real property is considered discharged on the date that the court grants the bankruptcy discharge because this is the moment that it becomes clear that the debt doesn't have to be paid.

COD income is also excludable from gross income if the debt is canceled when the taxpayer is insolvent.[8] A taxpayer is insolvent if the taxpayer's liabilities exceed the fair market value of his or her assets.[9] The amount of the exclusion is limited to the extent of the taxpayer's insolvency.[10] The extent of a taxpayer's insolvency is measured at the time immediately before the debt was canceled.[11]

In determining a taxpayer's insolvency, assets that are exempt from claims of creditors are included.[12] But contingent liabilities and liabilities that the taxpayer has guaranteed are not included unless it is more likely than not that the taxpayer will be called upon to pay them.[13] A nonrecourse liability is included in determining a taxpayer's insolvency, but only to the extent of the fair market value of the property that secures such a liability because the taxpayer will not be called upon to pay the excess.[14] Accrued interest is not included as a liability to the extent that its payment would give rise to a deduction.[15] Each spouse may determine his or her own extent of insolvency separately, even if the spouses file a joint return.[16]

The bankruptcy exclusion takes precedence over all other exclusions in IRC §108.[17] The insolvency exclusion is mandatory if the taxpayer is insolvent, and it takes precedence over the qualified farm and real property business indebtedness exclusions.[18] The qualified principal residence indebtedness exclusion takes precedence over the insolvency exclusion unless the taxpayer elects otherwise.[19]

Reduction of "Tax Attributes"

If a taxpayer qualifies for the bankruptcy, insolvency or qualified farm indebtedness exclusion, then the amount of the exclusion must be applied to reduce the taxpayer's "tax attributes" in the order listed below:[20]

- **Net operating loss (NOL) of the year of the debt discharge and any carryover to that year;**
- **General business credit carryovers to or from the year of the debt discharge;**
- **Minimum tax credit as of the beginning of the year**

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following the year of the debt discharge;

- **Capital loss of the year of the debt discharge and any carryover to that year;**
- **Basis of property;**
- **Passive loss carryover from the year of the debt discharge; and**
- **Foreign tax credit carryovers to or from the year of the debt discharge.**

Losses and basis are reduced by the excluded COD income dollar-for-dollar, tax credits are reduced $1.00 for every $3.00 of COD income.[21] The reduction of these items is made after the income tax for the taxable year of the discharge has been determined.[22]

What if the taxpayer has a carryover from the prior year such as a net operating loss (NOL) carryover, a capital loss carryover or a suspended passive activity loss carryover? An IRS regulation provides some clarification of the mechanics involved:[23]

> **(b) *Carryovers and carrybacks.*—The tax attributes subject to reduction under section 108(b)(2) and paragraph (a)(1) of this section that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are reduced pursuant to section 108(b)(2) and paragraph (a)(1) of this section.**

Consequently, the taxpayer may use the carryovers from the prior year in computing the tax for the year in which the debt was canceled, but if any amounts remain that would normally be carried over to the subsequent year, then they must be reduced.

If there are no reductions of the first four categories of "tax attributes" (NOL, general business credit, minimum tax credit, capital loss carryovers), then the basis of depreciable and nondepreciable property is the next category of "tax attributes" that will have to be reduced by the excluded COD income.[24] The reduction of the basis of property is made under the rules of section 1017. [25]

The ***time*** that the reduction of basis occurs is the beginning of the taxable year following the year in which the debt was canceled.[26] The ***amount*** of the reduction of basis is limited to the excess of the aggregate of the taxpayer's —

(1) adjusted bases of assets held immediately after the debt has been discharged, over

(2) liabilities owed immediately after the discharge. [27]

Note that this limitation involves the adjusted basis of assets, not fair market value.

IRS regulations provide rules for the reduction of basis in the case of more than one type of property.[28] The basis of real property used in a business or held for investment is reduced before personal property used in a business or held for investment. The basis of property not used in a business or held for investment is reduced last. If there is more than one property in a particular category (e.g. real property used in a business or held for investment) to which the basis reduction applies, then the reduction is allocated to the bases of the properties in proportion to their aggregate bases.[29]

Special Rules Applicable to Bankruptcy Cases

There are a few special rules that apply to bankruptcy cases. To understand these rules, it may be helpful to understand the mechanics of a bankruptcy case.

When an individual files a petition under Chapter 7 (liquidation) or Chapter 11 (reorganization), a bankruptcy estate is created, which generally includes all legal or equitable interests in property of the debtor as of the commencement of the case. The bankruptcy estate is treated as a separate taxable entity from the individual debtor. The bankruptcy estate continues until the bankruptcy proceeding is closed. The bankruptcy trustee is responsible for filing the estate's tax returns and paying its taxes.[30]

When a bankruptcy petition is filed, several "tax attributes" of the individual debtor that existed on the first day of the debtor's taxable year (i.e., January 1st) are deemed to be transferred to the bankruptcy estate.[31] These "tax attributes" include net operating loss carryovers, charitable contribution carryovers, recovery of tax benefit items, tax credit carryovers, capital loss carryovers, the basis, holding period and character of assets, the debtor's method of accounting, and other tax attributes as provided in regulations (unused passive activity losses, unused losses limited by the at-risk rules, and the principal residence exclusion).[32] Upon termination of the bankruptcy estate, the unused portions of the same tax attributes are deemed to be transferred back to the debtor.[33]

A net operating loss sustained by the bankruptcy estate may be carried back to a prior year of the debtor.[34] However, a net operating loss of a debtor that is sustained after the bankruptcy petition has been filed may not be carried back to a prior year of the debtor.[35]

COD income that results from the bankruptcy discharge is reportable on the return for the bankruptcy estate. For Chapter 7 and 11 cases, the tax attributes to be reduced are those of the bankruptcy estate, not the individual debtor.[36]

If the debt was discharged in bankruptcy, certain types of property are exempt from the basis reduction.[37] Examples of exempt assets are $15,000 of the value of a personal residence, $2,400 for a motor vehicle, $8,000 in household goods and furnishings, and qualified retirement plans. One of the ways of determining which assets are exempt is to review the schedule of the bankruptcy petition that lists the exempt assets.

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Examples

A couple of examples involving foreclosures will illustrate how the insolvency and bankruptcy exclusions work.

Example 1 – Insolvency Exclusion

Facts

- In 2003, Mr. and Mrs. Hall purchased a principal residence in Modesto for $500,000. They financed the purchase with a mortgage loan of $400,000.
- In 2005, the Halls obtained a refinance loan of $500,000 and paid off the original $400,000 loan. They used the remaining proceeds of the refinance loan to buy two cars and go on a much-needed vacation.
- In 2010, the Halls lost the residence in a non-judicial foreclosure. The refinance loan had a principal balance of $500,000, and the fair market value of the residence was $400,000. The lender canceled the $100,000 balance of the debt.
- At the time of the foreclosure, the Halls were insolvent to the extent of $120,000. Their liabilities included $35,000 of accrued and unpaid mortgage interest.
- At the time of the foreclosure, the Halls had a net operating loss carryover from 2009 in the amount of $10,000.
- After the foreclosure, the Halls' only other assets were a small bank account, two cars, and some household goods and furnishings. At this time, their remaining liabilities exceeded the bases of these assets.

Analysis

- None of the $100,000 of COD income qualifies for the principal residence indebtedness exclusion due to the ordering rule of IRC §108(h)(4).
- Although the Halls were insolvent to the extent of $120,000, their liabilities included $35,000 of accrued and unpaid interest, which, if paid, would have been deductible, and therefore, this liability must be eliminated. Their revised extent of insolvency was $85,000.
- Consequently, the Halls may exclude $85,000 of the $100,000 of COD income using the insolvency exclusion.
- The Halls may claim the $10,000 net operating loss carryover on their 2010 income tax return per Treas. Reg. §1.108-7(b).
- The Halls need not reduce the bases of their assets by the $85,000 insolvency exclusion because their liabilities exceeded the bases of their assets immediately after the foreclosure (see IRC §1017(b)(2)).
- The Halls had a nondeductible $100,000 loss on the foreclosure ($400,000 fair market value minus $500,000 basis).

Example 2 – Bankruptcy Exclusion

Facts

- On 9/8/2010, Jessie James filed a voluntary petition for Chapter 7 bankruptcy. In the petition, she listed her assets as cash, car, household goods and personal effects, and a qualified retirement account, all of which she reported as exempt under 11 U.S.C. §522. Ms. James' adjusted bases in these assets was $25,000. She didn't own a residence (lived in a rented apartment). In her petition, she also listed $150,000 of credit card debt.
- In her petition, Ms. James also listed residential rental property with a fair market value of $175,000 secured by a recourse debt of $300,000 owed to ABC Savings & Loan. Her adjusted basis in the property was $315,000.
- On 11/16/2010, ABC Savings & Loan filed a motion with the bankruptcy court to lift the automatic stay so that it could foreclose on the rental property. On 11/30/2010, the court granted the motion.
- On 12/8/2010, the court granted Ms. James a bankruptcy discharge, and on 12/22/2010, the case was closed.
- On 1/31/2011, ABC Savings & Loan foreclosed on the rental property and acquired it at the trustee's sale for $175,000, which was the fair market value of the property.
- As of 1/1/2010, Ms. James had no tax attributes other than the basis of property.

Analysis

- For 2010, the bankruptcy estate has COD income of $275,000, consisting of discharged credit card debt ($150,000) plus the excess of the debt on the rental property ($300,000) over its fair market value ($175,000).
- Since the debts were discharged on 12/8/2010, and since the bankruptcy estate didn't close until 12/22/2010, the bankruptcy estate reports the $275,000 of COD income on Form 982 attached to the 2010 return, and excludes all of it using the bankruptcy exclusion.
- Since the bankruptcy estate's only tax attribute immediately after the debts were discharged is the basis of property, the bankruptcy estate must follow the rules for reducing basis under IRC §1017.
- The basis of the rental property is a tax attribute that was transferred to Ms. James on 12/22/2010 per IRC §1398(i). It must be reduced on 1/1/2011 per IRC §1017(a).
- The basis of the rental property is reduced first per Treas. Reg. §1.1017-1(a)(1).
- The reduction of the rental property's basis is limited to the excess of the aggregate of the Ms. James' adjusted bases in property ($315,000 rental plus $25,000 other property) over her liabilities ($175,000 debt remaining after the bankruptcy discharge), or $165,000. Consequently, the rental property's adjusted basis is reduced from $315,000 to $150,000.

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- The bases of Ms. James' remaining assets ($25,000) are not reduced because these assets were treated as exempt in the bankruptcy proceeding (see IRC §1017(c)(1)).
- The foreclosure results in a gain of $25,000, which is equal to the fair market value of the property ($175,000) over its revised adjusted basis ($150,000).

Conclusion

I hope that this article has provided some clarity to the rules regarding the reduction of "tax attributes" required when the taxpayer excludes COD income under the bankruptcy or insolvency exclusions of Section 108.

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[1] See "Tax Aspects of Foreclosures and 'Short Sales'" (Jan. 2009); "Tax Aspects of Rental Property Foreclosures and 'Short Sales'" (Aug. 2009); "Tax Consequences of Foreclosures and Short Sales — Debunking the Myths" (Nov. 2010).

[2] 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. In a short sale, the principal amount of the debt minus the selling expenses of the short sale is the "amount realized."

[3] 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. The amount of COD income might be higher in a short sale than a foreclosure because in a short sale, the amount of COD income is the amount of debt that the lender cancels after applying the proceeds from the short sale against the debt, and the proceeds from the short sale are usually less than the FMV of the property.

[4] IRC §108(a)(1)(A). Title 11 includes bankruptcy cases filed under Chapters 7, 11, 12 and 13.

[5] IRC §108(d)(2).

[6] Johnson v. Commissioner, T.C. Memo. 2004-37.

[7] Cozzi v. Commissioner, 88 T.C. 435, 445 (1987); Friedman v. Commissioner, T.C. Memo. [8]1998-196.

[9] IRC §108(a)(1)(B).

[10] IRC §108(d)(3).

[11] IRC §108(a)(3).

Id.

[12] Carlson v. Commissioner, 116 T.C. 87 (2001).

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

[14] Revenue Ruling 92-53, 1992-2 C.B. 48.

[15] Lawinger v. Commissioner, 103 T.C. 428 (1994), fn. 4; Merkel v. Commissioner, 109 T.C. 463 (1997), fn. 17.

[16] IRS Letter Ruling 8920019 (May 19, 1989).

[17] IRC §108(a)(2)(A).

[18] IRC §108(a)(2)(B).

[19] IRC §108(a)(2)(C).

[20] IRC §108(b)(2).

[21] IRC §108(b)(3).

[22] IRC §108(b)(4).

[23] Treas. Reg. §1.108-7(b).

[24] IRC §108(b)(2)(E).

[25] Id.

[26] IRC §1017(a).

[27] IRC §1017(b)(2).

[28] Treas. Reg. §1.1017-1(a).

[29] Id.; See also Pub. 4681 (2010), page 9.

[30] IRC §6012(b)(4).

[31] IRC §1398(g).

[32] Id.; Treas. Reg. §1.1398-1, -2, and -3.

[33] IRC §1398(i).

[34] IRC §1398(j)(2)(A). However, the taxpayer might not be entitled to tax refunds resulting from NOL carrybacks to prior years because such refunds might be considered property of the bankruptcy estate. See Segal v. Rochelle, 382 U.S. 375 (1966); In Re Brett & Wendy Hooper, Case No. 09-bk-26224, 2010 TNT 241-15 (Bankr.Ct. Dist.Ariz. 2010).

[35] IRC §1398(j)(2)(B).

[36] IRC §108(d)(8).

[37] IRC §1017(c)(1), citing 11 U.S.C. §522.