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porate understatements of \$1,000,000 or more. This measure failed passage.

**SBX6 9** (Dutton) would have increased the research-and-development credit from 15 percent to 20 percent. This measure failed passage.

**SBX6 18** (Steinberg) would have exempted manufacturing equipment from the state share of the sales tax, and would have made the single sales factor apportionment formula mandatory. This measure failed passage.

**SBX6 19** (Florez) would have required the Franchise Tax Board to publish on its website the names of publicly traded business taxpayers receiving tax incentives and the amount of each incentive claimed if they are claiming at least \$20,000 worth of tax incentives. This measure failed passage.

**SBX6 8** (Dutton) would have exempted from state sales tax specified manufacturing equipment and property used in qualified research. This measure failed passage.

**SBX8 32** (Wolk) would have provided conformity to number provisions of federal law, including a 20 percent penalty for erroneous refunds. This measure was vetoed by the Governor.

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# Tax Consequences of Foreclosures and Short Sales – Debunking the Myths

By David M. Fogel, EA, CPA

**I**n 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. Since that time, I have answered numerous questions from tax practitioners about some of the practical problems encountered in reporting these transactions on income tax returns. Some of these problems involve “myths” spread by other tax practitioners. This article debunks ten of these “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 cancellation of debt income (COD income). Instead, the principal amount of the debt is treated as the “amount realized” in computing gain or loss.<sup>1</sup> 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.<sup>2</sup>

## Myth #1 – No debt was canceled because lender issued Form 1099-A

A lender that acquires property but does not cancel any debt is required to issue Form 1099-A.<sup>3</sup> A lender that cancels at least \$600 of a debt is required to issue Form 1099-C.<sup>4</sup> In many instances involving foreclosures, lenders have issued Form 1099-A, but not Form 1099-C. That means that the lender didn't cancel any debt, right?

**Wrong.** In California, lenders have a choice between using the judicial or nonjudicial foreclosure process. In a judicial foreclosure, the lender sues the borrower in court. This process is required if the lender wants to obtain a deficiency judgment to hold the borrower liable for the difference between the debt and the value of the property. In a nonjudicial foreclosure, the lender issues a notice of default to the borrower, and after a waiting period of almost 4 months, may sell the property at auction (trustee's sale). Nearly all foreclosures in California involve the nonjudicial process. If a lender uses the nonjudicial foreclosure process, then the lender is prohibited from seeking a deficiency judgment against the borrower.<sup>5</sup> As a result, the balance of the debt is canceled by operation of law.

## Myth #2 – Nonjudicial foreclosure converted debt from recourse to nonrecourse

If the lender used the nonjudicial foreclosure process, the debt was converted from recourse to nonrecourse, right?

**Wrong.** Several real estate attorneys have told me that this

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is a misinterpretation of section 580d. This section prohibits a deficiency judgment if the lender used the nonjudicial foreclosure process. It doesn't convert the borrower's personal liability for the debt from recourse to nonrecourse.

### Myth #3 – Debt was recourse because Form 1099-C says so

A client gives you a Form 1099-C that has box 5 checked "Yes" indicating that the borrower was personally liable for the debt. This means that the debt was recourse, right?

**Not necessarily.** In almost all instances I have seen, the lender checks the "Yes" box on this form.<sup>6</sup> You can't rely on the information on this form without verifying it with your client or from other sources.

For example, many personal residences were sold during 2005 and 2006 under an "80/20" financing arrangement in which there was a first mortgage loan for 80% of the purchase price, and a home equity line-of-credit (HELOC) loan for the remaining 20% of the purchase price. Since both of these loans were used to purchase the property, real estate attorneys will tell you that both loans are nonrecourse due to section 580b of the Calif. Code of Civil Procedure.

### Myth #4 – There is no COD Income because the FMV on Form 1099-C exceeds the debt

A client gives you a Form 1099-C for a canceled recourse loan that shows in box 7 the FMV of the property, and this amount is more than the principal amount of the debt. Based on this, there was no COD income, right?

**Wrong.** In many cases, the lender has not ascertained the correct FMV of the property. I have seen two instances where the lender entered the FMV of the property based on an appraisal obtained several years ago for the original loan. Ask your client what the FMV of the property was and/or determine it from other sources such as Zillow.com.

### Myth #5 – Where the debt was nonrecourse, a short sale results in COD income

As mentioned previously, where title to the property is transferred, if the debt is nonrecourse, then the principal amount of the debt is treated as the "amount realized" in computing gain or loss, and there isn't any COD income.

Some practitioners have theorized that a short sale results in different tax consequences than a foreclosure because a short sale is treated as two distinct and separate transactions — a loan modification (reduction of the principal amount of the loan) followed by a sale of the property with the proceeds of the sale going to the lender. Since a loan modification results in COD income whether the loan is nonrecourse or recourse,<sup>7</sup> under this theory the loan modification portion of the short sale results in COD income, right?

**Wrong.** In a short sale, the lender must approve the terms of the sale and will receive the sales proceeds. Cancellation of the debt and the sale of the property are integrated events that can't be separated. Even if they could, the Step Transaction

Doctrine<sup>8</sup> would combine the events into one transaction.

In *Stevens v. Commissioner*,<sup>9</sup> the Tax Court ruled that the debt involved in a short sale was recourse, and that as a result, the taxpayer was required to report COD income. However, in its opinion, the Court indicated that if the debt had been nonrecourse, then there would not have been any COD income because the principal amount of the debt would have been treated as the "amount realized" in computing gain or loss on the sale.<sup>10</sup> In addition, the Franchise Tax Board has posted an article on its website in which it concluded that there is no COD income in a short sale involving nonrecourse debt.<sup>11</sup>

### Myth #6 – Taxpayer who converted principal residence to rental use may use the principal residence exclusion for COD income

If the taxpayer has converted a principal residence to rental use, and if, at the time of the foreclosure or short sale, the taxpayer satisfies the requirements of IRC §121 (the home sale exclusion), then any COD income resulting from the foreclosure or short sale may be excluded under the principal residence exclusion of IRC §108, right?

**Wrong.** The problem is that at the time that the debt was canceled, it was no longer "qualified principal residence indebtedness" and therefore, it isn't eligible for this exclusion. Instead, the COD income might be excludable under the Qualified Real Property Business Indebtedness (QRPBI) exclusion.<sup>12</sup>

For a taxpayer's principal residence, COD income is excluded if "the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013."<sup>13</sup> "Qualified principal residence indebtedness" means acquisition indebtedness under IRC §163(h)(3)(B) with respect to the principal residence of the taxpayer.<sup>14</sup>

However, when a principal residence is converted to rental use, the debt no longer qualifies as acquisition indebtedness under IRC §163(h)(3)(B). Under IRS regulations, a change in use of the property requires the debt to be reallocated to reflect the new use.<sup>15</sup>

### Myth #7 – To calculate gain or loss, a taxpayer using the principal residence exclusion must reduce the basis of the residence

If a taxpayer's principal residence has been lost to foreclosure or a short sale resulting in COD income, and if the COD income is excludable under the principal residence exclusion, then the taxpayer must reduce the basis of that residence in calculating gain or loss, right?

**Wrong.** When a taxpayer excludes COD income under the principal residence exclusion, the law requires the taxpayer to reduce (but not below zero) the basis of the residence.<sup>16</sup> But in a foreclosure or short sale, the balance of the debt is canceled when the taxpayer no longer owns the residence. As a result, there is no basis to be reduced.

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The IRS provides an example of this situation in its publication on canceled debts.<sup>17</sup> In the example, John and Mary lose their principal residence to foreclosure, and they exclude \$25,000 of COD income using the principal residence exclusion. The IRS states that the basis of their residence is not reduced because at the time that the debt was canceled, John and Mary had lost the home to foreclosure and no longer owned it. According to the IRS, the basis is reduced only if the taxpayer continues to own the home after the debt has been canceled.<sup>18</sup>

### Myth #8 – Taxpayer must reduce the basis of rental property by the insolvency exclusion

If a taxpayer excludes COD income resulting from a foreclosure or short sale of rental property by using the insolvency exclusion, then the adjusted basis of the rental property must be reduced by the exclusion in order to calculate gain or loss, right?

**Wrong.** The adjusted basis is reduced only if the taxpayer uses the QRPBI exclusion. A taxpayer who was solvent immediately before the foreclosure or short sale who uses the QRPBI exclusion must reduce the basis of the rental property by the QRPBI exclusion.<sup>19</sup>

However, a taxpayer who was insolvent immediately before the debt was canceled is required to use the insolvency exclusion instead of the QRPBI exclusion because the insolvency exclusion takes precedence.<sup>20</sup> Under the insolvency exclusion, the taxpayer's "tax attributes" (net operating loss carryovers, certain tax credits, capital loss carryovers, basis of property, passive loss carryovers and foreign tax credit carryovers) must be reduced in this order, and the reductions are made at the beginning of the next tax year.<sup>21</sup>

### Myth #9 – Taxpayer may not claim net operating loss for rental property foreclosure

Many taxpayers who lost rental properties to foreclosure or short sale have excluded the COD income using the insolvency exclusion. In such cases, the foreclosure or short sale usually resulted in a large loss that caused a net operating loss (NOL). This NOL is one of the "tax attributes" that must be reduced before carrying it to another tax year, right?

**Wrong.** According to an IRS regulation, the NOL may be carried back to preceding tax years before the taxpayer is required to reduce it.<sup>22</sup> In addition, if the taxpayer had an NOL in a prior year that carried over to the current year in which the debt was canceled, that NOL is allowed in the current year before the taxpayer is required to reduce it.

### Myth #10 – Adjusted basis of personal residence converted to rental property is its original cost

In calculating the gain or loss on the foreclosure or short sale of a taxpayer's personal residence that was converted to rental property, the taxpayer's adjusted basis is its original cost, minus depreciation and the QRPBI exclusion, right?

**Not necessarily.** For the disposition of property that has

been converted from personal use to business use, the adjusted basis for calculating gain is not necessarily the same as the adjusted basis for calculating loss. The adjusted basis for calculating loss is the lesser of the original cost or FMV of the property at the time it was converted to rental use, minus depreciation and the QRPBI exclusion.<sup>23</sup> The adjusted basis for calculating gain is the original cost of the property, minus depreciation and the QRPBI exclusion.<sup>24</sup> In many instances, there won't be either a gain or a loss, such as if the "amount realized" is between these two numbers.

### Conclusion

I hope that this article has cleared up some 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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<sup>1</sup> *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.

<sup>2</sup> *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.

<sup>3</sup> IRC §6050J.

<sup>4</sup> IRC §6050P; *Treas. Reg. § 1.6050P-1(a)*.

<sup>5</sup> See §580d of the California Code of Civil Procedure.

<sup>6</sup> In fact, the instructions for box 4 of Form 1099-A (FMV of property) state, "If an abandonment or voluntary conveyance to the lender in lieu of foreclosure occurred, check "Yes" in box 5 and enter the appraised value of the property."

<sup>7</sup> *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987); *Rev. Rul. 82-202*, 1982-2 C.B. 35, amplified by *Rev. Rul. 91-31*, 1991-1 C.B. 19.

<sup>8</sup> The Step Transaction Doctrine is a judicially developed concept which is a subset of the more general "substance over form" doctrine of *Gregory v. Helvering*, 293 U.S. 465 (1935). It treats a series of separate "steps" as a single transaction if such steps are "in substance integrated, interdependent and focused toward a particular end result."

<sup>9</sup> *Stevens v. Commissioner*, T.C. Summary Opinion 2008-61.

<sup>10</sup> Although this case can't be cited as precedent because it is a T.C. Summary Opinion, I think that it shows the Tax Court's thinking along these lines.

<sup>11</sup> [http://www.irs.gov/professionals/taxnews/2009/July/Article\\_9.shtml](http://www.irs.gov/professionals/taxnews/2009/July/Article_9.shtml)

<sup>12</sup> See IRC §§108(a)(1)(D) and 108(c). See also my article in the August 2009 issue.

<sup>13</sup> IRC §108(a)(1)(E).

<sup>14</sup> IRC §108(h)(2).

<sup>15</sup> See *Treas. Reg. § 1.163-8T(j)(1)(i)(B)*.

<sup>16</sup> IRC §108(h)(1).

<sup>17</sup> See IRS Pub. 4681 ("Canceled Debts, Foreclosures, Repossessions and Abandonments"), Example 2 on page 15.

<sup>18</sup> *Id.* at page 9. See also the instructions to IRS Form 982.

<sup>19</sup> IRC §1017(b)(3)(F)(iii).

<sup>20</sup> IRC §108(a)(2)(B).

<sup>21</sup> IRC §§108(b)(2) and (4).

<sup>22</sup> *Treas. Reg. § 1.108-7(b)*.

<sup>23</sup> *Treas. Reg. § 1.165-9(b)(2)*.

<sup>24</sup> *Treas. Reg. § 1.1012-1(a)*.