Tax Aspects of Rental Property Foreclosures and "Short Sales"

BY DAVID M. FOGEL, EA, CPA

In the January 2009 issue of the *California Enrolled Agent*, I discussed the tax consequences of foreclosures and "short sales" involving a taxpayer's principal residence. What happens if the property involved is a rental? Is there a similar exclusion of cancellation-of-debt income under section 108 for rental properties? If so, what are the requirements for claiming this exclusion? If the property used to be the taxpayer's principal residence that was later converted to rental use, may the taxpayer use the qualified principal residence exclusion? This article expands on my earlier article and answers these questions.

Is Rental Property Debt Considered Recourse or Nonrecourse?

A debt is nonrecourse if the lender cannot hold the borrower personally liable for it and may go only against the value of the property that is securing the debt in order to collect. A debt is recourse if the lender can hold the borrower personally liable for it beyond the value of the property that is securing the debt.

In California, a purchase money mortgage — a loan in which the borrowed funds are used to purchase owner-occupied property such as a personal residence — is treated as nonrecourse debt.[1] However, a debt secured by rental property is almost always considered recourse debt because the property is not owner-occupied. If there is any doubt about whether the debt is recourse or nonrecourse, a real estate attorney should be engaged to review the loan documents and make the determination. For purposes of this article, I will assume that rental property debt is considered recourse debt.

Tax Consequences of Rental Property Foreclosures and "Short Sales"

If a lender discharges any part of a debt, then the taxpayer must recognize the amount discharged as ordinary income.[2]

As stated in my previous article, where the unpaid indebtedness is recourse, the foreclosure or "short sale" transaction is split into two parts consisting of —

1. Ordinary income from cancellation of debt (COD) equal to the outstanding principal amount of debt owed minus the fair market value of the property; and
2. Gain or loss equal to the fair market value (FMV) of the property minus its adjusted basis.[3]

If the borrower qualifies, he or she may be able to use one of the relief provisions available in IRC §108 to exclude the COD income from gross income. Examples include the bankruptcy exclusion, the insolvency exclusion, the exclusion for qualified real property business indebtedness, and the principal residence exclusion.

To qualify for the Qualified Real Property Business Indebtedness (QRPBI) exclusion, the debt must be "qualified real property business indebtedness." IRC §108(c)(3) states that this phrase means indebtedness which —

A. Was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property,
B. Was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and
C. With respect to which such taxpayer makes an election to exclude the income.

If the taxpayer qualifies for this exclusion, then the COD income is excluded from gross income and applied, instead, to reduce the taxpayer's adjusted basis of the property.[4] The exclusion is limited to the excess of the principal amount of the qualified debt over the FMV of the property,[5] and also limited to the taxpayer's basis in the property,[6] and limited overall to the taxpayer's aggregate adjusted bases of all depreciable real properties.[7] California conforms to the federal QRPBI exclusion.[8]

Is Renting Real Property Considered a Business?

With respect to IRC §108(c)(3)(A) (was the debt incurred in connection with real property used in a business?), historically, the courts have held that the rental of even a single property may constitute a trade or business under various provisions of the Code.[9] However, the ownership and rental of property does not always constitute a trade or business.[10] The issue of whether the rental of property is a trade or business is ultimately one of fact in which the scope of a taxpayer's activities, conducted either personally or through agents, are so extensive as to rise to the stature of a business.[11]

In a 1983 Technical Advice Memorandum (TAM),[12]

the IRS announced that it would take the position that the mere rental of real property does not constitute a trade or business under IRC §1231. Both IRC §1231 and IRC §108(c)(3)(A) refer to property "used in a trade or business".[13] As a result, taxpayers may be concerned about whether the IRS will allow the QRPBI exclusion to be used for rental real property, because if the IRS's position is that such property doesn't constitute a trade or business, then it may disallow the taxpayer's QRPBI exclusion.

In reaching its conclusion in the 1983 TAM, the IRS relied mostly upon *Curphey v. Commissioner*.[14] The IRS misinterpreted the decision to hold that the ownership and rental of real property does not, as a matter of law, constitute a trade or business. In fact, the Tax Court stated just the opposite, and ruled that whether the taxpayer's ownership and rental of real property constitutes a trade or business depends upon the facts and circumstances of the case.[15]

After issuing its 1983 TAM, the IRS held, in a series of 14 identical letter rulings, that a multi-tenant office building held by a limited partnership for rental to tenants qualified as a trade or business under IRC §108(c)(3)(A).[16] Similarly, the IRS ruled that a multi-unit residential building held by a general partnership for rental to tenants qualified as a trade or business under IRC §108(c)(3)(A).[17] Two court cases ruled that the holding of a single rental property should be treated as consisting of two activities — a rental activity and an investment activity and that the rental activity was not engaged in for profit, i.e., was not a business.[18] However, in both of these cases, the taxpayers did not rent the properties to the general public and the rentals were seasonal and of short duration.[19] In another case, the IRS argued that the taxpayer's holding of a single rental property consisted of two activities, but the court rejected this argument.[20] The property was rented continuously at fair rental value.

The issue of whether a particular taxpayer's rental real property constitutes a trade or business under IRC §108(c)(3)(A) has not, apparently, been litigated. As demonstrated by letter rulings issued after 1983, the IRS has apparently backed away from its position that the mere renting of real property does not constitute a business for purposes of IRC §108(c)(3)(A). As demonstrated by subsequent court precedents, whether such an activity is a business appears to be a "facts and circumstances" issue.

> **"Understanding how to apply the rules of foreclosures and short sales is a key to helping your client take adventures of any available inclusions."**

What is "Qualified Acquisition Indebtedness"?

With respect to IRC §108(c)(3)(B) (was the debt "qualified acquisition indebtedness"?), IRC §108(c)(4) states that this phrase means indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve the property.

Refinancing indebtedness also qualifies, but only to the extent that it doesn't exceed the refinanced indebtedness (the principal balance of the debt paid off by the refinance loan).[21] However, to the extent that the proceeds from the refinance loan are used to substantially improve the property, that portion will qualify. But if the proceeds from the refinance loan are not used to substantially improve the property, that portion won't be eligible for the QRPBI exclusion.

Making the QRPBI Election

The QRPBI election described in IRC §108(c)(3)(C) must be made on a return that is filed by the due date (including extensions) for the year in which the taxpayer has COD income.[22] The election is made by filing IRS Form 982 with the return.

Principal Residence Converted to Rental Use

If a taxpayer's principal residence is subsequently converted to rental use, and there is COD income from a foreclosure or "short sale," which exclusion under IRC §108 applies? The Qualified Principal Residence Indebtedness exclusion under IRC §108(a)(1)(E) and (h), or the QRPBI exclusion under IRC §108(a)(1)(D) and (c)?

IRC §§108(a)(1)(D) and (E) state that the exclusion depends upon "the indebtedness discharged." Accordingly, whether

the taxpayer qualifies for the principal residence exclusion or the QRPBI exclusion depends upon the use of the property at the time that the debt is canceled. If the property is being used as the taxpayer's principal residence, then the principal residence exclusion applies. If the property was previously the taxpayer's principal residence, but has subsequently been converted to rental use, then the QRPBI exclusion applies.

Examples

A couple of examples will illustrate the application of these rules.

Example 1

In January 2007, Mr. and Mrs. Franklin purchased residential rental property for $355,000, paying $55,000 down and obtaining a $300,000 interest-only recourse loan. During the latter portion of 2007, the Franklins stopped making loan payments. The Franklins deducted $5,000 in depreciation on their 2007 return.

In January 2008, when the fair market value of the property was $200,000, the lender foreclosed on the property and canceled the $300,000 debt. The Franklin's adjusted basis in the property was $350,000 ($355,000 cost minus $5,000 depreciation). The Franklins were not insolvent at the time that the debt was canceled, and they didn't own any other depreciable real property.

As a result of the debt cancellation, the Franklins had $100,000 of COD income ($300,000 debt minus $200,000 FMV). Assuming that they make the QRPBI election to exclude this income by filing Form 982 with their 2008 return, they will qualify to exclude all of the COD income for both federal and California income tax purposes.

The Franklins will have a $50,000 loss on the foreclosure, computed as follows:

FMV of rental property		$200,000
Less:		
Cost basis	$355,000	
2007 depreciation	(5,000)	
QRPBI exclusion	(100,000)	
Adjusted basis	250,000	(250,000)
Loss on foreclosure		($50,000)

Example 2

In May 2000, Mr. and Mrs. Grant purchased their principal residence for $400,000, paying $80,000 down, and obtaining a $320,000 nonrecourse loan. In January 2004, when the fair market value of the residence had risen to $1,000,000 and the existing loan was $300,000, they obtained a refinance loan of $800,000, paid off the $300,000 existing loan, and put the $500,000 loan proceeds in a savings account.

In January 2005, Mr. and Mrs. Grant moved out of the residence and began renting it to tenants. They used the $500,000 in the savings account to purchase a new principal residence.

In January 2009, the FMV of the rental property had fallen to $600,000, the principal balance owed on the loan was $750,000, and they were in default on the payments. They transacted a "short sale" of the property by selling it for $600,000 to a third party. All of the proceeds from the sale went to the lender. The lender canceled the $150,000 remaining balance owed on the debt.

On their 2005, 2006, 2007 and 2008 income tax returns, the Grants claimed depreciation deductions on the rental property of $10,000 ($40,000 total). The Grants were not insolvent at the time that the debt was canceled, and they didn't own any other depreciable real property.

As a result of the debt cancellation, the Grants had $150,000 of COD income ($750,000 debt minus $600,000 FMV).

None of the COD income is excludable under IRC §108(a)(1)(E) (the principal residence exclusion) because at the time that the debt was canceled, the property was not the Grants' principal residence. The taxpayers can't use this exclusion.

Do the Grants qualify for the QRPBI exclusion under IRC §108(a)(1)(D)? Let's go through the requirements:

- IRC §108(c)(3)(A) — was the debt incurred or assumed by the taxpayer in connection with real property used in a trade or business, and was it secured by such real property? Yes.
- IRC §108(c)(3)(B) — was the debt incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, was it qualified acquisition indebtedness?

  IRC §108(c)(4) defines "qualified acquisition indebtedness" as "indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property."

  The paragraph immediately after IRC §108(c)(3)(C) provides that "qualified acquisition indebtedness" includes refinance debt, but only to the extent that the refinance loan paid off the original loan. Therefore, only $300,000 of the $800,000 refinance loan is "qualified acquisition indebtedness."

  At the time the debt was canceled, the $800,000 refinance loan had been paid down to $750,000. Only $300,000 of this $750,000 principal balance is "qualified acquisition indebtedness" that qualifies for the exclusion, which is more than enough to absorb the $150,000 of COD income.
- IRC §108(c)(3)(C) — does the taxpayer elect to exclude

the income under this section? Yes. The election is made by filing Form 982 with a timely-filed tax return (including extensions).

- IRC §108(c)(2)(A) — is the excludable COD income limited by the excess of the qualified real property business indebtedness over the FMV of the property?

  The language of this section requires the taxpayer to take the qualified debt ($300,000, not $750,000) and reduce it by the FMV of the property ($600,000), and the amount that's excludable is limited to this excess. Since there is no excess, none of the COD income is eligible for the QRPBI exclusion.

Therefore, none of the $150,000 of COD income qualifies for the QRPBI exclusion.

The Grants will have a $240,000 gain on the "short sale," computed as follows:

FMV of rental property		$600,000
Less:		
Cost basis	$400,000	
Less: depreciation taken	(40,000)	
Adjusted basis	360,000	(360,000)
Gain on "short sale"		$240,000

Conclusion

The tax aspects of rental property foreclosures and "short sales" depend upon many variables as discussed above. The analysis can get quite complicated. If the lender cancels the debt, the client may be entitled to exclude the income resulting from such cancellation under IRC §108. Understanding how to apply these rules is important to determining whether your client may take advantage of the exclusions available.

David M. Fogel, EA, CPA is a self-employed tax consultant and frequent contributor to *California Enrolled Agent*. He provides tax consulting services to other tax practitioners and represents clients before the various tax agencies. David has more than 34 years of experience in tax controversies, including 26 years working for the IRS (8 years as a Tax Auditor and Revenue Agent, 18 years as an Appeals Officer), and 6 years as a tax advisor for law firms in Sacramento. David is an Enrolled Agent, a CPA, and is also admitted to practice before the United States Tax Court. He can be reached by email at dfogel@surewest.net or on the Internet at www.fogelcpa.com

Endnotes

1 See §580b of the California Code of Civil Procedure.
2 IRC §61(a)(12).
3 Treas. Reg. §1.1001-2(a)(2). See also Treas. Reg. §1.1001-2(c), Example (8); and Revenue Ruling 90-16, 1990-1 C.B. 12.
4 IRC §108(c)(1).
5 IRC §108(c)(2)(A).
6 IRC §108(c)(1)(A).
7 IRC §108(c)(2)(B).
8 §17131, Calif. Rev. & Taxation Code.
9 See, e.g., Hazard v. Commissioner, 7 T.C. 372 (1946, Acq. 1946-2 C.B. 3); Post v. Commissioner, 26 T.C. 1055 (1956, Acq. 1958-2 C.B. 7); Gilford v. Commissioner, 201 F.2d 735 (2d Cir. 1953); Schwarcz v. Commissioner, 24 T.C. 733 (1955, Acq. 1956-1 C.B. 5); Elek v. Commissioner, 30 T.C. 731 (1958, Acq., 1958-2 C.B. 5); Fegan v. Commissioner, 71 T.C. 791 (1979), aff'd. 81-1 USTC (CCH) ¶9436 (10th Cir. 1981); Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940).
10 See Neili v. Commissioner, 46 B.T.A. 197 (1942) (nonresident alien was not in the trade or business of renting a single building where the rents were collected by her attorney); Rev. Rul. 73-522, 1973-2 C.B. 226 (nonresident alien was not in the trade or business of renting real estate where the leases were "net leases").
11 Bauer v. United States, 168 F. Supp. 539, 541 (Ct. Cl. 1958) (undivided interest in stock of corporation that owned an apartment building was not a business); Schwarcz v. Commissioner, 24 T.C. 733 (1955) (taxpayer's management of two apartment buildings in Budapest, Hungary qualified as a business). See also Higgins v. Commissioner, 312 U.S. 212 (1941) (management of the taxpayer's own investment portfolio not a business).
12 TAM 8350008 (Aug. 23, 1983).
13 Well, there is a minor difference: IRC §1231 uses the word "the" instead of "a."
14 Curphey v. Commissioner, 73 T.C. 766 (1980).
15 Id. at 774-775.
16 Letter Rulings 9426006 through 9426019 (Mar. 25, 1994).
17 Letter Ruling 9840026 (June 30, 1998).
18 Vandeyacht v. Commissioner, T.C. Memo. 1994-148 (the rental of a taxpayer's waterfront condominium and house in Sarasota, Florida, which were held for rental and investment purposes, was not an activity engaged in for profit, despite the fact that the properties were held for appreciation); Rivera v. Commissioner, T.C. Summary Opinion 2004-81 (the ski-season rental of a taxpayer's property in Truckee, California, which was held for rental and investment purposes, was not an activity engaged in for profit, even though the property was held for appreciation).
19 In Vandeyacht, the taxpayers rented only to friends or their adult children, and in Rivera, the taxpayers rented only to acquaintances and coworkers. The seasonal nature of the rentals and the fact that the taxpayers didn't rent to the general public probably resulted in the Court's bifurcation of the activities into rental and investment activities.
20 Mayes v. United States, 60 AFTR2d (RIA) 5046, 87-2 USTC (CCH) ¶9478 (W.D.Mo. 1986) (where the taxpayer's house in Hilton Head, South Carolina was held for rental and investment purposes, the rental of which was only a functional part of holding the property for appreciation and future sale, the court considered both undertakings as a single activity for purposes of deciding whether the activity was engaged in for profit).
21 See the last sentence of IRC §108(c)(3).
22 Treas. Reg. §1.108-5(b).