

Tax Consequences of Foreclosure

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Tax Consequences in Foreclosure

- Two distinct taxable Events:
- 1. Cancellation of debt
- 2. Gain or loss

Gain or loss on Principal Residence

- Gain-Exception IRC Sec. 121:
 - TP can exempt up to \$250,000 in gain. (\$500,000 for married filing jointly)
 - 5 year residence requirement ending on date of sale or exchange
- Loss:
 - is personal cannot offset any other income. IRC Sec. 162(c).
- See Publication 544

Status of Mortgage

- Recourse vs Nonrecourse
- Recourse – a personal note
- Nonrecourse - cannot hold the borrower personally liable

Tax Consequence

- Nonrecourse debt (NRD) produces no Cancellation of debt income.
- Amount realized in foreclosure, for purpose of gain and loss on NRD, includes the full debt cancelled not just amount received in sheriff's sale.

1099-A or C

- In foreclosure the Lender should send a 1099-A to determine loss or gain.
- If the lender cancels part of the debt they must send a 1099-C.

CANCELLATION OF DEBT(COD)

- Gross income
 - includes all income from whatever source derived IRC 26 U.S.C. Sec. 61(a).
- Gross income
 - includes COD sec. 61(a)(12)
 - The elimination of a liability makes available to the taxpayer assets previously offset to pay liabilities. United states v Kirby Lumber, 52 s.Ct 4(1931)

COD

- COD can include:
 - Credit cards _____
 - Car Loans _____
 - Some Student Loans _____
 - Mortgages _____
- Any debt discharged by an applicable entity in access of \$600 when an identifiable event occurred _____

Applicable Entities

- IRC Sec. 6050P:
 - Financial Entity _____
 - Credit Unions _____
 - Governmental Units _____

Identifiable Event

- Fed. Tax Reg. Sec. 1.6050P(b): Some events:
 - Discharge in Bankruptcy _____
 - When SOL for collection runs out _____
 - Foreclosure _____
 - By agreement for less than full consideration _____
 - By defined policy of creditor _____

Informational Return

- Cancellation of debt is reported to the IRS by the issuance of a 1099-C _____

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1099-C (2009)

1 Amount of debt cancelled \$

2 If reported if included in box 2 Form 1099-C

3 Debtor's name

4 Debt description

5 Was borrower personally liable for repayment of the debt? Yes No

6 Check for bankruptcy If fair market value of property \$

7 For Internal Revenue Service Center File with Form 1096.

8 For Prudent Act and Payment Protection Act Notice, see the 2009 General Instructions for Forms 1099, 1040, 1041, 1042, 1043, 1044, and 1045.

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Issues with 1099-C

- TPs who lost home in foreclosure might not get 1099-C (last Address Rule)
- Amounts listed in Box 2 "Amount of Cancelled Debt" often inaccurate. This should be original principal less FMV of repossession if collateral
- FMV in Box 7 may be inaccurate if sale not at arms length .

Disputes

- TP needs to be prepared to rebut presumption that the amounts are correct.
- IRS prefers TP and Lender resolve disputes regarding information reported.

Exclusions from Gross Income

- IRC Sec. 108:
 - Discharge occurs in a:
 - Title 11 (bankruptcy) case,
 - Discharge when the TP is insolvent.
 - Indebtedness discharged in farm indebtedness,
 - In the case of a TP other than a corporation the indebtedness discharged is qualified real property
 - Business indebtedness
 - Indebtedness discharged is principal residence indebtedness which is discharged before 1/1/2013

Bankruptcy Exclusion

- IRC Sec. 108(a)(1)(A):
 - Income from COD is excluded if the Taxpayer is bankrupt.
- IRC Sec. 108(d)(2):
 - The debt must be discharged by the Court or pursuant to a court approved plan of liquidation or reorganization.

Insolvency Exclusion

- IRC Sec. 108(a)(1)(B),
- IRC Sec. 108(d)(3): "Insolvent" means the excess of liabilities over the fmV of assets.
- See worksheet in Publication 4681 pg 6

Insolvency Worksheet	
Line Item	Amount
1. Total assets	
2. Total liabilities	
3. Excess of assets over liabilities	
4. Total amount of debt discharged	
5. Total amount of debt discharged that is not QPRI	
6. Total amount of debt discharged that is QPRI	
7. Total amount of debt discharged that is not QPRI and is not dischargeable in bankruptcy	
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Principal Residence Exclusion

- The Mortgage Forgiveness Debt Relief Act of 2007
- IRC Sec 108(a)(1)(E):
 - Gross income does not include discharged indebtedness for a "qualified principal Residence"
 - Discharged prior to 1/1/13
 - Must be made on a timely Filed tax return.
 - Can amend within 6 months and can make election by writing "Filed Prusuant to Sec. 301.9100-2"

Principal Residence

- IRC Sec. 108(h)(5)Principal Residence:
 - The home the TP ordinarily lives most of the time.
- 108 (h)(5), Sec. 121.
 - Only one home.
 - No vacation homes.

Qualified Principal Residence Indebtedness (QPRI)

- QPRI - Acquisition indebtedness IRC Sec. 108(h)(2), Sec. 106(h)(3)(B).
- Acquisition Indebtedness
 - Acquiring
 - Constructing; or
 - Substantially improving a principal residence.
- The cancellation must be related to either:
 - A decline in value in the residence's value, or
 - A decline in the TP's financial situation.

Refinancing

- QPRI also includes:
 - Debt secured by the residence for refinance provided it is to construct or improve the residence and provided it does not exceed the refinanced debt.
 - No money for credit card
 - Payoffs, vacations, new cars, student loans etc.

Ordering Rules

- Bankruptcy exclusion applies first.
- Insolvency exclusion can be applied last (TP Decision).
- If QPRI includes acquisition debt and home equity debt the
 - QPR exclusion only applies to the extent amount of cancelled debt exceeds the loan amount that is not QPRI.
- See: Example pg 8 Publication 4681

Exclusion Limit

- \$2,000,000
Limit for QPRI.
IRC Sec. 108(h)(2). _____
- \$1,000,000 for
married filing
separate. _____

How to claim Exclusions

- Form 982
 - Complete and attach to tax return _____
 - Check part I depending on Exclusion. _____
 - Attach supporting materials: Bankruptcy Petition and discharge, or _____
 - Calculations of Insolvency. _____

982 Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

Part I General Information (see instructions)

1. Amount included in due to check applicable boxes:

2. Discharge of indebtedness in year 11 only: _____

3. Discharge of indebtedness to the extent excluded just in a sale 11 only: _____

4. Discharge of qualified farm indebtedness: _____

5. Discharge of qualified real property business indebtedness: _____

6. Discharge of qualified mortgage indebtedness: _____

7. Discharge of certain indebtedness of a qualified individual because of insolvency: _____

8. Total amount of discharged indebtedness excluded from gross income: _____

9. Do you own or use all real property described in section 1082(c)(1) relating to property sold for sale? _____

Part II Basis Adjustment (see instructions)

10. Indebtedness of the taxpayer (or other debtor) is reported on an individual's bankruptcy or insolvency proceedings, and the taxpayer (or other debtor) is not a partner in the partnership, trust, or other entity that is a partner in the partnership, trust, or other entity: _____

Part III Consent of Corporation to Adjustment of Basis of its Property Under Section 1082(c)

Under section 1082(c), the corporation cannot claim the excluded S _____ from its gross income for the tax year beginning _____ and ending _____.

Under this section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(c) in effect at the time of this filing for the tax year for that year. This adjustment is reported under the basis of _____.

Part IV Other Information

11. Do you have any other information that you want to report? _____

What if client forgets?

- File appeal or correspondence letter if IRS sends CP-2000 Under-reporter notice
 - Attach information to establish position. _____
- Petition Tax Court. _____
- File audit reconsideration. _____

Reduction of tax attributes

- Basis: Cost IRC Sec. 1012 (a)
- Amounts excluded under IRC Sec. 108(a):
 - Bankruptcy and Insolvency exclusions reduce basis at the start of the next tax year: _____
 - Applied proportionately on all other assets owned by TP. _____
 - Gain recaptured on the sale of these assets attributable to the exclusion is treated as ordinary income. IRC Sec. 1017(d) _____
 - Report on 10(a) Form 982 _____

Personal Residence Exclusion (PRE)

- TP who excludes indebtedness under PRE are required to reduce the basis of their PR by the amount excluded.
 - Reduction is immediate. IRC Sec. 108(h)(1). _____
 - Gain after foreclosure allocable to Sec. 108 exclusion for PR is subject to Sec. 121 gain exclusion \$250,000. _____
 - Amounts in excess are subject to Capital gains rates. _____
 - Reported on 10(b) of Form 982 _____

Election

- If insolvency or PR exclusion apply, TP can elect depending on whichever is most beneficial.

Resources

- Internal Revenue Code Title 26
- Federal Tax Regulations
- Publication 4681
- Publication 544
- www.irs.gov

Does filing a 1099-C really cancel indebtedness?

- Leonard v. Old National Bank Corporation, 837 N.E.2d 543 (Ind. 2005)
 - 1099-C is nothing more than an "informational filing" That in and of itself does not cancel the debt.
 - Something more affirmative act of cancellation needed.
