## Tax Consequences of Foreclosure

Philip J. Rosenkranz Staff Attorney

The Legal Aid Society of Milwaukee, Inc.

### 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

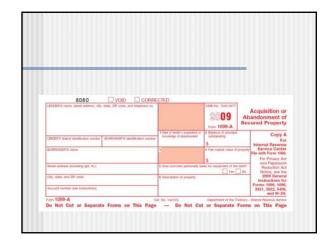
- Recourse vs Nonrecourse
- Recourse –a personal note
- Nonrecourse cannot hold the borrower personally liable

#### 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)

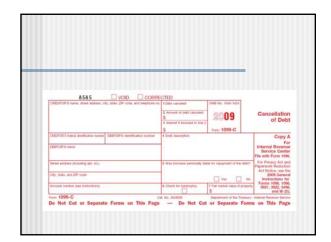
- Gross income
  - includes all income from whatever source derived IRC 26 U.S.C. Sec. 61(a).
- Gross income
  - includes COD sec. 61(a)(12)
  - The elimination of a liability makes available to the taxpayer assets previously offset to pay liabilities. <u>United states v Kirby lumber.</u>, 52 s.Ct 4(1931)

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

Applicable E	Entities
<ul> <li>IRC Sec. 6050P:</li> <li>Financial Entity</li> <li>Credit Unions</li> <li>Governmental Units</li> </ul>	

Identifiable E	vent
<ul> <li>Fed. Tax Reg. Sec.</li> <li>1.6050P(b): Some events:</li> <li>Discharge in Bankruptcy</li> <li>When SOL for collection runs out</li> </ul>	
<ul> <li>Foreclosure</li> <li>By agreement for less than full consideration</li> <li>By defined policy of creditor</li> </ul>	

Informational	Return
■ Cancellation of debt is reported to the IRS by the issuance of a 1099-C	



#### 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,
- farm indebtedness,

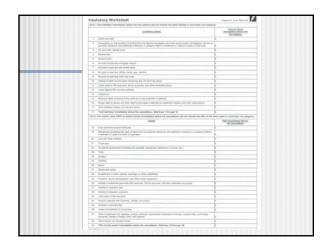
  In the case of a TP other than a
- corporation the indebtedness discharged is qualified real property
- Business indebtedness
- Indebtedness discharged is principal residence indebtedness which is discharged before 1/1/2013

#### **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



# 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 Resid	dence
<ul> <li>IRC Sec. 108(h)(5)Principal Residence: <ul> <li>The home the TP ordinarily lives most of the time.</li> <li>IRC Sec.</li> </ul> </li> <li>108 (h)(5), Sec. <ul> <li>121.</li> <li>Only one home.</li> <li>No vacation homes</li> </ul> </li> </ul>	

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

Refinancing	
<ul> <li>QPRI also includes:</li> <li>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.</li> <li>No money for credit card</li> <li>Payoffs, vacations, new cars, student loans etc.</li> </ul>	

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

#### **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.

rum 982	Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustmen	t) min. on on	
Separation of the Training	➤ Attach this form to your income tax return.	Reporter to 94	
Tame stoom on when	tied.	phy reader	
ETTE General	Information (see instructions)		
a Clecharge of ind b Clecharge of ind	is due to joheck applicable bookel) tradeem in a site 11 com. Anothere to the extent insolvent just in a Site 11 com;		
d Chicharge of qui	Hed farm indiktedness Hed med properly business indictedness Hed principal residence indiktedness as indictedness of a qualited individual because of Midenstein dissesses as indictedness of a qualited individual because of Midenstein dissesses	8	
2 Total arrount of 3 Do you elect to	Secharyed indebtedness excluded from gross income.  met all real property described in section 1221(a)(1) missing to property held 1 ordinary course of a trade or business, as F2 were depreciable property/1.	or made to	
Reduction bearing of the	ominary course or a mode or triument, as it is used depreciation progenty; in oil Tax. Attribution, You must attach a description of any transactions in oil Tax. Attribution in the section or other triuments of the section or other partnership consent statements. For additional information, one the institu-	reiting in the reduction in grules, and, if applicable,	
	of from gross income: I qualified maj properly business indebtledness, applied to reduce the basis of		
depreciable real	reports	4	
5 That you elect u	der section 159/505 to apply first to reduce the basis Londer section 1017) of	6	
6 Applied to moke	my, any not operating loss that occurred in the tax year of the discharge or corried as of the discharge	4	
	any general business credit curryove to or from the tax year of the discharge	7	
the tax year of the Applied to reduce	e discharge any net supital loss for the tax year of the discharge including any supital loss tax year of the discharge		
the Applied to reduce 6, 00 NOT use	the basis of condepositable and depositable property if not reduced on line the case of discharge of qualified form indebtedness.	10a	
	the basis of your principal residence. Enter arount here CPLY if line to is	100	
61 For a discharge of a Commission prop	qualified form indebtheses, applied to reduce the basis of ty used or held for use in a trade or business, or for the production of income, if a \$1.	114	
	of for use in a trade or business of farring	19	
a Other property of	red or held for use in a trade or business, or for the production of income,	550	
12 Applied to reduce	any passion activity loss and credit carryovers from the tax year of the discharge	42	
13 Applied to reduc	any livelys has credit conyoner to or from the has year of the decharge	13	
ETTE Consent	of Corporation to Adjustment of Basis of its Property Under Section	1000(4)(2)	
for the tox year begin Under that section, the	org, and ending corporation consents to have the basis of its property adjusted in accordance wit § in effect at the time of tiling its income tax nature for that year. The corporation	the regulations prescribed	
	(the Ferryodis)  this description of the transactions resulting in the nonrecognition of an		

#### What if client forgets?

- File appeal or correspondence letter if IRS sends CP-2000Underreporter 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 is 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.