

**REAL ESTATE PROPERTY FORECLOSURE and  
CANCELLATION OF DEBT  
AUDIT TECHNIQUE GUIDE**

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# Chapter 1 – Overview

This guide discusses the tax consequences for real estate property that is disposed of through foreclosure, short sale, deed in lieu of foreclosure, and abandonments. Although, the term foreclosure is used throughout this document, the tax treatment also applies to short sales, deed in lieu of foreclosures, and abandonments. A discussion is also devoted to cancellation of debt income exclusions that are most commonly applicable to these types of dispositions and community property considerations. This guide primarily focuses on tax consequences for individual taxpayers. Keep in mind that the examples presented in this Audit Technique Guide are general examples and should not solely be relied upon for every situation as each fact pattern may change the tax consequences.

## Brief History

According to the U.S. Department of Housing and Urban Development (HUD) and the U.S. Department of the Treasury's December 2013 Housing Scorecard, 3.6 million cumulative completed foreclosures occurred from April 2009 through October 2013. This number includes investment, second home, and jumbo mortgage properties (high-end properties).

Many taxpayers were unaware that even though their lender foreclosed on their properties, there could be tax consequences and the lender could legally pursue collection of any outstanding deficiency. In 2009, the government stepped in to help distressed homeowners and implemented various assistance programs, such as the Making Home Affordable Program, as a strategy to help homeowners avoid foreclosure, stabilize the country's housing market, and improve the nation's economy. Federal and State governments have filed numerous lawsuits against lending institutions for unfair and/or fraudulent practices. As a result, mortgage lenders have implemented changes.

Internal Revenue Code §61(a)(12) provides that gross income includes income from discharge of indebtedness. When money is borrowed, the loan proceeds are not included in income because an obligation to repay the lender exists. Generally, when debt for which a taxpayer is personally liable is subsequently forgiven, the amount received as loan proceeds is reportable as income because an obligation to repay the lender no longer exists, which results in an economic benefit to the taxpayer.

Under IRC §108(a) taxpayers may exclude discharged debt if the taxpayer is bankrupt, insolvent, the discharged debt is qualified farm indebtedness, the discharged debt is qualified real property business indebtedness, or if the discharged debt is qualified principal residence indebtedness. Form 982 is completed to report the exclusion and the reduction of certain tax attributes either dollar for dollar or 33 1/3 cents per dollar.

PLR 8918016, 1989 WL 595222, states that, “[A]ccording to legislative history of the Bankruptcy Tax Act of 1979, the purpose of IRC §108 is to accommodate both tax and bankruptcy policies. Due to the Supreme Court’s decision in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), tax policy requires debtors to include in gross income the amount of debt they are no longer required to repay, including debts discharged in bankruptcy.”

The Mortgage Forgiveness Debt Relief Act of 2007 is a well-publicized act that allows qualifying taxpayers to exclude debt discharged as income from a borrower's principal residence. Consequently, IRC §108(a)(1)(E) was added to the Internal Revenue Code.

## **Exceptions**

Gifts, deductible debt, and purchase price reduction are exceptions to IRC §61(a)(12) where discharged debt is not taxable. These exceptions apply before the exclusions under IRC §108(a)(1) and do not require a reduction of tax attributes.

### ***Gifts***

If forgiveness of the debt is a gift, then generally, it is not considered income. However, the donor may be required to file a gift tax return.

### ***Deductible Debt (lost deduction)***

If the payment of the debt would result in a deduction, then the cancellation of the debt is not included in gross income. For example, Marvin was discharged of \$50,000 (\$20,000 principal and \$30,000 interest) of mortgage debt. If Marvin would have made the mortgage payments, he may have been able to deduct the \$30,000 as mortgage interest expense on his tax return. Since Marvin did not make his mortgage payments, the \$30,000 is a lost deduction. Thus, Marvin's cancellation of debt income is \$20,000.

### ***Purchase Price Reduction***

If the seller reduces the amount of debt owed for property purchased, the reduction generally does not result in cancellation of debt income. The reduction of the debt is treated as a purchase price adjustment and reduces the property's basis. In comparison, if a bank or financial institution that holds the mortgage note reduces or modifies the balance of the loan, the debt restructure is treated as a loan modification and is not considered a purchase price reduction. For example, Jane purchased a residence from Jamie and obtains a mortgage loan from a third party, Adam. During escrow, Jamie decides to reduce the purchase price of the property due to a problem discovered during the house inspection. Jamie's reduction of the purchase price is considered a purchase price reduction and not cancellation of debt.

## **Definitions**

**Foreclosure** – A legal procedure by which mortgaged real estate property is sold by the lender in full or partial satisfaction of the mortgage debt. For example, if the borrower fails to pay the monthly mortgage payments, the lender takes the property back and sells it to recover some or all of the debt. If proceeds from the sale fail to pay recourse debt in full, the lender may obtain a deficiency judgment in court to recover the outstanding balance. The foreclosure proceeding and whether the lender is able to obtain a deficiency judgment is determined by the law of the state where the property is located.

**Short sale** - A sale of mortgaged real estate property in which the proceeds from selling the property will fall short of the total balance owed by the borrower. Short sale agreements do not necessarily release the borrower from their obligation to repay any loan deficiency unless specifically agreed to between the lender and property owner and governing state law.

**Deed in Lieu of Foreclosure** – The borrower returns the property back to the lender in full satisfaction of the mortgaged outstanding debt balance upon an agreement by the lender. The principal advantage to the borrower is that it immediately releases him/her from most or all of the personal indebtedness associated with the defaulted loan.

**Nonrecourse Debt** – The borrower is not personally liable and repossession of the mortgaged property, for example, will generally satisfy the outstanding debt.

**Recourse Debt** – The borrower is personally liable for the loan. Meaning, the lender can obtain a deficiency judgment against the borrower in court for any outstanding balance that is not satisfied through a foreclosure sale. State law of where the property is located governs whether the lender is able to obtain a deficiency judgment.

**Cancellation of Debt Income (CODI)** – Also known as cancellation of indebtedness income (COII) – If a lender forgives a borrower of all or part of an outstanding debt owed, the borrower is considered to have received a benefit that has put him/her into a better financial position. The amount of the benefit must be reported as income received under IRC §61(a)(12), unless the taxpayer qualifies for an income exclusion under IRC §108.

**Home Affordable Modification Program** - Any Pay-for-Performance Success Payments that reduce the principal balance of the home mortgage under the Home Affordable Modification Program are not taxable.

**HUD-1 Settlement Statement ([Job Aid 2](#))** - This form is used as a statement of actual charges and adjustments paid by the borrower and the seller. The concept is similar to that of the T-account where all incoming and outgoing amounts of the real estate transaction are listed. Both parties receive a copy of this statement before or at closing.

**Relocation Assistance** - Some taxpayers qualify for relocation funds to assist with moving expenses. These programs are offered through federal, state and local government, and lenders. The taxpayer may receive monies for their principal residence, rental property and investment property. These funds are taxable and included in the gain/loss computation.

## Key Tax Issues

Foreclosure issues may not be as cut and dry as Schedule C advertising expenses and are very factual, circumstantial and specific. One fact or circumstance could change the result of how the foreclosure is reported on the return. Questions should be asked and documents gathered that will address the issues of whether the foreclosure, short sale or deed in lieu of foreclosure resulted in a recognized gain or loss and cancellation of indebtedness income, and how these amounts should be reported on the taxpayer's tax return. Other issues arise when a taxpayer excludes cancellation of debt income. Chapter 9, Audit Strategies, includes a discussion on case file documentation, job aids, resources, and contact information. For example, Job Aid 2 is a sample IDR and [JobAid3](#) contains sample interview questions for the disposition of a principal residence.

Foreclosures, short sales and deeds in lieu of foreclosure are considered dispositions. Keep in mind that if a taxpayer is involved in a short sale he/she will know the date the property was sold and the sales amount, because he/she will work closely with the real estate agent and lender during the short sale process. The closing HUD-1 ([JobAid4](#)) will show the amount of the loan that will be satisfied by the sale. The total loan balance will conceptually be equal to the amount on the closing HUD-1 and the amount of debt forgiven. In comparison, a taxpayer does not become aware of the identifying information regarding a disposition through a foreclosure, until after the lender sells the property and generally issues a Form 1099-C.

Once a lender repossesses real estate property through a foreclosure or the lender becomes aware that the property owner abandoned the property, the lender should issue the taxpayer a Form 1099-A (Acquisition or Abandonment of Secured Property). If the lender also forgives or cancels part or all of the outstanding debt, a Form 1099-C (Cancellation of Debt) should be issued to the taxpayer. If the lender forecloses on the property and forgives the debt within the same year, then the lender is only obligated to issue a Form 1099-C for debt canceled of \$600 or more. The taxpayer should contact the bank if the information is incorrect so that corrected forms are issued.

Confusion arises when a taxpayer receives a Form 1099-A in one year and a Form 1099-C in a subsequent year for a recourse note. A foreclosure is a disposition within the meaning of IRC §1001 (*Helvering v. Hammel*, 311 U.S. 504 (1941)). The foreclosure sale ends the mortgagor's ownership in the property, and at that time, the gain or loss from the sale or other disposition of the mortgaged property should be determined (*Helvering v. Hammel*, 311 U.S. 504 (1941)). Refer to discussion in Chapter 2, Nonrecourse and Recourse Debt for additional information.

The Service has observed that lenders may issue Forms 1099 only for the primary loan. All property loans should be considered in the determination of any cancellation of debt income as well as gains or losses. Therefore, it is important to ask the taxpayer questions about the events leading up to and after the disposition. To identify all loans associated with the disposed property, search property records and IRPTR, or review prior years' returns for mortgage interest. Sometimes a lender may erroneously fail to issue the taxpayer a Form 1099-C. Facts and circumstances will dictate when or if any outstanding debt has been discharged, absent the issuance of a Form 1099-C. Under IRC §7491(a)(1), under certain circumstances, in any court proceeding, the burden shifts to the IRS to prove that the taxpayer received cancellation of indebtedness income if the taxpayer provides credible evidence with respect to any factual issue relevant to ascertaining the income tax liability of the taxpayer. See discussion later on Form 1099-A and Form 1099-C.

Consideration of whether the lender has pursued collection activity and the state where the property is located are two primary factors. Each state has its own foreclosure legal laws and time frames that a lender must pursue collection activities. Absent a Form 1099-C, it is reasonable to conclude that the taxpayer was forgiven the outstanding balance if the lender has not pursued collection activity in accordance with the state law of the location of the property. For example, if a foreclosure is completed by non-judicial means in some states, the lender is precluded from pursuing a deficiency judgment for the outstanding balance.

Some states, shown in Table 1, *Anti-Deficiency/Nonrecourse States*, have anti-deficiency laws which prohibit a lender from pursuing a deficiency judgment against the borrower under certain circumstances. Although, these states are identified as Anti-Deficiency states, it is important to note that each of these states has its own rules and the anti-deficiency rules are not applied in the same manner. It is important to understand the state law where the property is located as it could make a difference in the amount of income includable in taxable income or excludable from taxable income.

<b>Table 1. ANTI-DEFICIENCY / NONRECOURSE STATES</b>	
Alaska	North Carolina
Arizona	North Dakota
California	Texas
Connecticut	Utah
Idaho	Washington
Minnesota	

It is advised to seek assistance from local Counsel for specific state questions regarding foreclosures. Refer to the Local Law Section in IRM 5.17, Legal Reference Guide for Revenue Officers for more information.

In general, if indebtedness is canceled or forgiven, the amount canceled or forgiven must be included in gross income. If CODI is excluded from income, it generally will postpone the income tax liability on cancellation of indebtedness through the reduction of tax attributes.

## Chapter 2 – Type of Debt

### Nonrecourse and Recourse Debt

As defined earlier, a loan is nonrecourse if the taxpayer is not personally liable and the bank cannot pursue the taxpayer for any outstanding balance after the property is foreclosed. The loan is recourse if the taxpayer was personally liable for repayment of the loan and the bank has the right to pursue collection of all or part of the outstanding balance after the foreclosure. The lender may have indicated on Form 1099 whether the taxpayer was personally liable or not. Consultation with local Counsel regarding state law may assist in identification of the type of loan. Each loan type has different tax consequences. Although, a taxpayer no longer owns their foreclosed property, a reportable gain or taxable CODI from the disposition could result because foreclosures, short sales, and deeds in lieu of foreclosure are treated as taxable dispositions.

### Gain and Loss Computation and Cancellation of Debt Income

The computation of gain or loss from the sale or other disposition of property is located in IRC §1001. The gain is the excess of the amount realized over the adjusted basis. The loss is the excess of the adjusted basis over the amount realized.

The amount realized is defined in IRC §1001(b) as money received plus the fair market value of the property received (other than money). As discussed later, the amount realized for nonrecourse notes is the greater of the fair market value (FMV) of the property or the outstanding loan amount. The amount realized for recourse notes is the lesser of the fair market value of the property or the outstanding loan amount. Treas. Reg. §1.1001-2 discusses the gain or loss when there is a discharge of liabilities. Examples of dispositions for nonrecourse and recourse notes are under Treas. Reg. §1.1001-2(c).

Confusion exists as to the year that the disposition should be reported when the lender repossesses property and then sells it in a subsequent year. If the note that secured the property was nonrecourse, the disposition is reported in the year of repossession. If the note that secured the property was recourse, the disposition is reported in the year of the foreclosure sale.

[Diagram1,DebtFlowchart](#) (PDF), displays the taxable consequences of nonrecourse and recourse debt. Each consequence is explained in detail.

## ***Nonrecourse debt***

A loan is nonrecourse if the taxpayer is not personally liable and the bank cannot pursue the taxpayer for any outstanding balance after the property is foreclosed. The borrower is not personally liable and repossession of the mortgaged property, for example, will generally satisfy the outstanding debt. Generally, there is no CODI from foreclosure of property with nonrecourse debt. However, situations may exist where a taxpayer will have CODI from nonrecourse debt. Refer to Example 5, which is an example of CODI from nonrecourse debt.

As displayed in Diagram 1, discussed earlier, nonrecourse debt generally has one tax consequence to consider and that is whether a recognized gain or loss from the disposition exists. The gain/loss calculation is the amount realized less the adjusted basis. For nonrecourse debt, the amount realized is the greater of the outstanding debt of all loans immediately before the foreclosure or fair market value of the property plus the proceeds received from the foreclosure (e.g., relocation payment from the lender). The adjusted basis immediately before the foreclosure is subtracted from the amount realized to determine the gain or loss.

IRC §7701(g) states that the sales price is the greater of the FMV or the outstanding loan balance for nonrecourse loans to determine the gain or loss.

In *Commissioner v. Tufts*, 461 U.S. 300 (1983), the Supreme Court held that when a taxpayer “sells or disposes of property encumbered by a nonrecourse obligation exceeding the fair market value of the property sold, as in this case, the Commissioner may require him to include in the “amount realized” the outstanding amount of the obligation; the fair market value of the property is irrelevant to this calculation.” The Court reasoned that because a nonrecourse note is treated as a true debt upon inception (so that the loan proceeds are not taken into income at that time), a taxpayer is bound to treat the nonrecourse note as a true debt when the taxpayer is discharged from the liability upon disposition of the collateral, in spite of the lesser fair market value of the collateral.

**Example 1.** Maxine paid \$200,000 for her second home. She put \$15,000 down and borrowed the remaining \$185,000 from a bank. Maxine is not personally liable for the loan, but pledges the house as security. The bank foreclosed on the mortgage because Maxine stopped making payments. When the bank foreclosed on the loan, the balance due was \$180,000, the fair market value of the house was \$170,000, and Maxine’s adjusted basis was \$175,000 due to a casualty loss she had deducted. Maxine has a gain of \$5,000 (\$180,000 outstanding debt minus \$175,000 adjusted basis) from the foreclosure.

The lender’s foreclosure on property secured by nonrecourse debt that is greater than the FMV of the property does not result in cancellation of debt income. The entire amount of the nonrecourse debt is treated as the amount realized. As such, Maxine recognized no CODI upon the foreclosure, but realized \$180,000, the outstanding debt balance immediately before the foreclosure. Her gain is the difference between the loan balance of \$180,000 and the adjusted basis of \$175,000. Maxine has a \$5,000 recognized gain from the foreclosure of her second home. The disposition is reported on Form 8949, *Sales and Other Dispositions of Capital Assets* and Schedule D, *Capital Gains and Losses*.

Generally, there is no cancellation of debt income from foreclosure of property when nonrecourse debt secures the property, because repossession of the mortgaged property will satisfy the outstanding debt. The lender’s foreclosure on property secured by nonrecourse debt that is greater than the FMV of the property does not result in cancellation of debt income. The entire amount of the nonrecourse debt is treated as the amount realized.

However, in certain situations, the discharge of nonrecourse debt will result in CODI. Revenue Ruling 91-31, 1991-1 C.B. 19 provides that the reduction of the principal amount of an undersecured nonrecourse debt (nonrecourse debt greater than the fair market value of the property) results in CODI. For example, a reduction in the loan balance through a loan modification will result in CODI when nonrecourse debt exceeds fair market value of the property.

Confusion exists as to the year that the disposition should be reported when the lender repossesses property and then sells it in a subsequent year. If the note that secured the property was nonrecourse, the disposition is reported in the year of repossession.

**Example 2.** Walter paid \$580,250 for his second home. He paid \$30,000 down and borrowed the remaining \$550,250 from a bank. Walter is not personally liable for the loan, but pledges the house as security. When the fair market value of the property dropped to \$400,000 and the loan balance was \$535,698, the bank agreed to modify his loan and reduced the principal balance by \$52,435.

Walter did not qualify to exclude the cancellation of debt income from gross income under IRC §108. Therefore, Walter would report \$52,435 as other income on Form 1040, line 21, for the discharged nonrecourse debt.

### ***Recourse debt***

The loan is recourse if the taxpayer was personally liable for repayment of the loan and the bank has the right to pursue collection of all or part of the outstanding balance after the foreclosure. As displayed in Diagram 1, Debt Flowchart, discussed earlier, recourse debt has three different potential tax consequences which are (1) CODI, (2) gain/loss from the disposition, and (3) the reduction of tax attributes if CODI is excluded from income. The first calculation is to determine the amount of cancellation of debt income. Cancellation of debt income is determined by the outstanding debt balance immediately before the foreclosure (minus debt liable after the foreclosure) minus the fair market value of the property equals the cancellation of debt income.

Cancellation of debt income may be excluded if the taxpayer qualifies under IRC §108. Form 982 is used to report the exclusion and any reduction of certain tax attributes

Taxable cancellation of debt income is reported as:

- Non-business Debt – Form 1040 as other income.
- Sole Proprietorship – Schedule C or F as other income, if the debt is related to a sole proprietorship nonfarm or farm business.
- Non-Farm Rental Activity – Schedule E as other rental income, if the debt is related to a nonfarm rental of real property.
- Farm Rental Activity – Form 4835 to report rental income based on crops or livestock produced by a tenant.

In general, if taxable income (including CODI) is derived from a trade or business and is reported on a Schedule C or F, then it is self-employment income and it will be subject to self-employment tax. If an exception applies to exclude CODI from gross income, the CODI is also not self-employment income subject to self-employment tax. Self-employment income means the “net earnings from self-employment derived by an individual” IRC §1402(b). Net earnings from self-employment is defined as “the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are

attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in IRC §702(a)(8) from any trade or business carried on by a partnership of which he is a member” IRC §1402(a) and Treas. Reg. §1.1402(a)-1.

The second tax consequence for a recourse note is the calculation of the gain or loss from the foreclosure sale. The gain or loss is calculated as the amount realized plus any proceeds received from the foreclosure (e.g., relocation payment from the lender) minus the adjusted basis of the property immediately before the foreclosure sale. The amount realized is the lesser of the fair market value of the property or outstanding debt balance.

The fair market value of a property may be in question during an examination. That is because the sales price of the property is generally determined to be the fair market value of the property. This amount may be different from the amount reported on Form 1099-A. In *Frazier v. Commissioner* 111 T.C. 243, 246 (1998) the court stated, “Absent clear and convincing proof to the contrary, the sale price of property at a foreclosure sale is presumed to be its fair market value.” See *Community Bank v. Commissioner*, 79 T.C. 789, 792 (1982), *affd.* 819 F.2d 940 (9th Cir.1987).

The third potential tax consequence of a recourse note is the reduction of tax attributes when cancellation of debt income is excluded from gross income. Generally, tax attributes are reduced by the amount of CODI excluded from income. Reduction of tax attributes is discussed later under Reduction of Tax Attributes in Chapter 4.

Confusion exists as to the year that the disposition should be reported when the lender repossesses property and then sells it in a subsequent year. If the note that secured the property was recourse, the disposition is reported in the year of the foreclosure sale.

Property which secures a taxpayer's recourse obligation is not worthless prior to foreclosure. *Commissioner v. Green*, 126 F. 2d 70, 72 (3d Cir. 1942) (“where, as here, the taxpayer is liable for the debt, interest and taxes by virtue of the mortgage or the bond thereby secured, the property continues, until foreclosure sale, to have some value which, when determined by the sale, bears directly upon the extent of the owner's liability for a deficiency judgment.”). Likewise, property which secures a taxpayer's recourse obligation may not be considered abandoned for purposes of a loss deduction prior to foreclosure. *Daily v. Commissioner*, 81 T.C. 161 (1983) (an attempt to abandon property subject to recourse debt does not result in a deductible loss), *aff'd*, *Daily v C.I.R.*, 742 F.2d 1461 (9th Cir. 1984). Once the year of disposition is identified and the type of debt is identified that secured the real estate property, the computation of the gain or loss and any CODI can be made.

**Example 3.** Marcus bought his second home for \$400,000 in 2003. He paid \$30,000 down and borrowed the remaining \$370,000 from a bank. Marcus is personally liable for the loan and the house is pledged as security for the loan. Marcus lost his job in January 2010 and the bank declined his requests for a loan modification. Although, Marcus found another job in October 2010, he earned less and was unable to make the mortgage payments and the bank ultimately foreclosed on the home in 2012. Marcus moved out of the home in 2012.

The recourse debt balance before the foreclosure was \$350,000. The bank sold the property for \$250,000 to a third party. After the foreclosure sale, the bank forgave \$60,000 of the \$100,000 debt in excess of the FMV (\$350,000 minus \$250,000) and Marcus remained liable for the \$40,000 balance. He did not qualify for any of the exclusions in IRC §108(a)(1).

Marcus has cancellation of debt income of \$60,000 (\$350,000 debt balance immediately before the foreclosure minus \$40,000 amount personally liable immediately after the foreclosure sale

minus \$250,000 FMV of the property). Under the circumstances, Marcus has other income of \$60,000 from the canceled debt. His nondeductible loss is \$150,000 (\$250,000 FMV of the property minus \$400,000 adjusted basis of the property).

Marcus would file Form 982 to report the CODI exclusion and complete Part I for discharge of qualified principal residence indebtedness. Marcus should also report the foreclosure on Form 8949, Sales and Other Dispositions of Capital Assets as a nondeductible loss. For more details, see Nondeductible Losses in the instructions to Schedule D, Capital Gains and Losses.

**Example 4.** Jimmy took out a recourse loan for \$700,000 to purchase an office building to expand his sole proprietorship realty business. Three years later, through a loan modification, the bank forgave \$78,000 of the loan balance when the FMV of the property was \$600,000. Jimmy would report \$78,000 on Schedule C as other income if he did not qualify to exclude some or the entire amount of CODI under IRC §108.

***Analysis of Disposition of Property Secured by Nonrecourse or Recourse Debt:***

The primary difference between nonrecourse and recourse debt is the timing and amount of any potential taxable income from the disposition and cancellation of debt income demonstrated in the following table. For this analysis, the outstanding loan balance is \$300,000, the fair market value of the property is \$265,000, and the adjusted basis is \$280,000. The cancellation of debt income is \$35,000 (\$300,000 outstanding loan balance minus \$265,000)

<b>Analysis of Disposition of Property</b>		
<b>Description</b>	<b>Nonrecourse</b>	<b>Recourse</b>
Amount realized	\$300,000	\$265,000
Minus adjusted basis	280,000	280,000
Equals gain/(loss)	<b>\$ 20,000</b>	(15,000)
Add cancellation of debt income		35,000
Equals net gain on disposition		<b>\$ 20,000</b>

The nonrecourse note results in a gain of \$20,000 (\$300,000 amount realized minus \$280,000 adjusted basis). Whereas, the recourse note results in a disposition loss of \$15,000 (\$265,000 amount realized minus \$280,000 adjusted basis) plus \$35,000 of cancellation of debt income resulting in a net gain of \$20,000. The overall tax consequence for both notes is a gain of \$20,000. However, the \$35,000 cancellation of debt income can be deferred through the reduction of tax attributes if the taxpayer qualifies to exclude the cancellation of debt income under IRC §108.

## Chapter 3 – Income from Discharge of Indebtedness

### IRC §108 Items Specifically Excluded from Gross Income

As stated earlier, a foreclosure is a taxable disposition which may result in recognized CODI and recognized gain. However, CODI can be excluded if the taxpayer qualifies under IRC §108. Keep in mind that the exclusions under IRC §108 do not apply to the amount of gain recognized from a foreclosure, short sale, or deed in lieu of foreclosure. Recognized gain and CODI are two separate calculations. A taxpayer may exclude CODI under IRC §108(a)(1) if:

- A. The discharge occurs in a bankruptcy case,
- B. The discharge occurs when the taxpayer is insolvent,
- C. The discharged indebtedness is qualified farm indebtedness,
- D. The discharged indebtedness is qualified real property business indebtedness (valid election), or
- E. The discharged indebtedness is qualified principal residence indebtedness.

IRC §108(a)(2) prescribes the coordination of the exclusions and is summarized in Table 2, Coordination of Exclusions. Bankruptcy takes precedence over all other exclusions. An insolvent taxpayer would first look to whether his/her situation qualified under the bankruptcy exclusion. If he/she did not qualify then, the insolvency exclusion would be considered. A farmer would first look to whether his/her situation qualified under the bankruptcy exclusion, then insolvency, then the farm exclusion. A taxpayer who qualified under the real property business exclusion, would first look to whether his/her situation qualified under the bankruptcy exclusion, then insolvency, then the real property business exclusion. A taxpayer who qualified under the principal residence exclusion, would first look to whether his/her situation qualified under the bankruptcy exclusion, then the principal residence exclusion. A taxpayer may make an election to apply the insolvency exclusion instead of the principal residence exclusion.

**Table 2. ORDER AND COORDINATION OF EXCLUSIONS**

IRC 108 Exclusions	1	2	3
<b>Bankruptcy</b>	Bankruptcy		
<b>Insolvency</b>	Bankruptcy	Insolvency	
<b>Farm</b>	Bankruptcy	Insolvency	Farm
<b>Business</b>	Bankruptcy	Insolvency	Business
<b>Principal Residence</b>	Bankruptcy	Principal Residence (or election to apply insolvency instead)	Insolvency

If canceled debt is excluded from income under one or more of these provisions, generally, tax attributes are reduced by the amount excluded (but not below zero). This is discussed later under Reduction of Tax Attributes in Chapter 4. These exclusions do not apply to any gain realized from foreclosure or short sale or deed in lieu of foreclosure.

Below is a discussion of the exclusions. Please note that this guide will not cover qualified farm indebtedness in detail. Refer to [Publication 4681](#), Canceled Debts, Foreclosures,

Repossessions and Abandonments and [Publication225](#), Farmer's Tax Guide, for more information.

## ***Bankruptcy***

The general underlying principle of bankruptcy is to provide a debtor an avenue to pay what the debtor can afford while receiving forgiveness for debt that cannot be satisfied. For example, in a Chapter 7 bankruptcy, a trustee takes control of the debtor's bankruptcy estate assets, liquidates nonexempt property, and distributes the cash to creditors. Remaining unpaid debts are generally discharged. After the trustee winds down the affairs, if any property remains, the trustee will transfer the property back to the debtor. Refer to IRM 5.9 Bankruptcy and Other Insolvencies, for additional information. IRM Exhibit 5.9.1-1 includes a glossary of common bankruptcy insolvency terms. Examiner responsibilities are discussed in IRM 4.27.2.

IRC §108(a)(1)(A) allows for cancellation of debt income to be excluded from income where the debt was discharged in a bankruptcy case. However, merely filing for bankruptcy does not meet this exclusion – the debt must have been discharged during the course of the bankruptcy case. As discussed earlier, the bankruptcy exclusion takes precedence over the other exclusions in IRC 108(a)(1).

Once you discover that a taxpayer has filed for bankruptcy, it is important that you contact the bankruptcy coordinator in Technical Services who would be able to provide information about the bankruptcy. It is important to know the status of the bankruptcy, because it could affect how you proceed with the case. If applicable, communicate with the Collection Officer assigned to the case in a timely manner so that Collection is able to take appropriate action within required timeframes.

## **Examination Consideration**

The bankruptcy exclusion is NOT an election. Although, Form 982 is used to report the exclusion type, amount of CODI excluded from gross income, and the tax attribute reduction, it is not required to be filed with a tax return for the bankruptcy exclusion. Failure to attach a Form 982 to a tax return does not prevent a taxpayer from excluding cancellation of debt income under the bankruptcy exclusion. As such, a taxpayer can present documentary evidence for consideration during an examination. An examiner should gather all necessary documents and develop relevant facts to determine whether a taxpayer meets the bankruptcy exclusion.

**Example 5 (Part I of Chapter 4, [Example 18](#)).** Tara owed several creditors and was no longer able to meet her financial obligations, as a result, she filed for Chapter 7 bankruptcy and was granted a discharge of her recourse debt of \$174,678 in 2012. Tara excluded the \$174,678 from taxable income on her 2012 Form 1040 return and attached Form 982 to report the exclusion and amount. She checked line 1a to report that the discharge was in a title 11 case (bankruptcy) and entered \$174,678 on line 2 of Form 982. Tara is also required to reduce tax attributes. Refer to [Example 18](#) for the attribute reduction calculation.

## ***Insolvency***

IRC §108(a)(1)(B) provides that gross income does not include cancellation of debt income if the discharge occurs when the taxpayer is insolvent. This exclusion takes precedence over the qualified farm and qualified real property business exclusions.

IRC §108(d)(3) defines insolvent as the excess of liabilities over the fair market value of assets, **immediately before the discharge**. A taxpayer can exclude cancellation of debt income up to the amount of insolvency per IRC §108(a)(3). The CODI amount excluded cannot exceed the amount by which a taxpayer is insolvent. A spouse does not realize CODI from their spouse's discharge of debt.

### **Audit Techniques**

- Review the taxpayer's insolvency calculation for reasonableness and request supporting documentation as warranted.
- Look for any liabilities that might be associated with a corresponding asset. For example, if a car loan is listed, the fair market value of the vehicle should be listed under assets, unless the vehicle was repossessed.
- Generally, mortgage lenders will conduct an appraisal of the property during a short sale process. Thus, a comparison of the fair market value on the Forms 1099-A and/or 1099-C with the taxpayer's insolvency calculation can be done to identify any differences. If you do identify any differences, request that the taxpayer explain how they determined the fair market value for the property especially, if the difference puts the taxpayer in an insolvent position.
- Taxpayers with high monthly income may in fact be insolvent. The insolvency calculation considers the taxpayers overall financial position right before the discharge of debt.

### **Examination Consideration**

Similar to the bankruptcy exclusion, the insolvency exclusion is NOT an election. Although, Form 982 is used to report the exclusion type, amount of CODI excluded from gross income, and the tax attribute reduction, it is not required to be filed with a tax return for the insolvency exclusion. Failure to attach a Form 982 to a tax return does not prevent a taxpayer from excluding cancellation of debt income under the insolvency exclusion. Failure to attach a Form 982 to a tax return does not prevent a taxpayer from excluding cancellation of debt income from gross income. As such, a taxpayer can present documentary evidence for consideration during an examination. An examiner should gather all necessary documents and develop relevant facts to determine whether a taxpayer meets the insolvency exclusion.

### **Insolvency Calculation**

Both tangible and intangible assets are included in the calculations. Assets also include exempt assets as defined by state law. The separate assets of a debtor's spouse are not included in determining the extent of insolvency of the debtor. For more information, refer to Chapter 8, Community and Common Law Property System discussed later.

Both recourse and nonrecourse liabilities are included in the insolvency computation, while contingent liabilities are not included. Accrued but unpaid interest expenses and income taxes that have become an obligation of the debtor, along with other fixed and certain claims are considered liabilities of the debtor. The separate liabilities of a debtor's spouse are not included in the calculation of the debtor. Refer to Chapter 8, Community and Common Law Property Systems discussed later for more information.

In *Shepherd et ux. v. Commissioner*, T.C. Memo. 2012-212, the court decided that the taxpayers did not meet their burden to prove the fair market value of two properties at the time of discharged debt and the taxpayers failed to include at least a percentage (amount he was able to withdraw), of the husband's retirement account, as an asset in their insolvency calculation.

Job Aid 1, an Insolvency Worksheet included in Chapter 9, Audit Strategies, can be used to determine the extent of insolvency. The worksheet is also located in Publication 4681.

**Example 6 (Part I of Chapter 4, [Example 20](#)).** Ashley was unable to pay her recourse mortgage for her second home after her divorce. She entered into a deed in lieu of foreclosure agreement with the lender on October 1, 2012, and was forgiven of the outstanding debt. The bank subsequently issued a Form 1099-C for \$50,000 discharged debt.

Ashley's total liabilities immediately before the cancellation were \$756,589 and the FMV of her total assets immediately before the cancellation were \$726,329. In this case, Ashley is insolvent to the extent of \$30,260 (\$756,589 total liabilities minus \$726,329 FMV of her total assets) immediately before the cancellation. Ashley can exclude only \$30,260 of the \$50,000 canceled debt from income under the insolvency exclusion. IRC §108(a)(3). Ashley would report \$19,740 (\$50,000 debt forgiven minus \$30,260 extent of insolvency) of the CODI as other income on her Form 1040. She would also attach Form 982 to her tax return, and check line 1b and enter \$30,260 on line 2. Ashley would also complete Form 982 Part II to reduce her tax attributes as illustrated in Example 20.

*Revenue Ruling 92-53, 1992-2 C.B. 48:*

What happens if a taxpayer is partially discharged of a nonrecourse debt when applying IRC §108(d)(3), insolvency exclusion? Revenue Ruling 92-53, 1992-2 C.B. 48 addresses the treatment of nonrecourse indebtedness when applying the insolvency exclusion. The ruling states that, "...the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent within the meaning of section 108(d)(3) of the Code, but only to the extent that the excess nonrecourse debt is discharged." Excess nonrecourse debt is the amount of nonrecourse debt that exceeds the fair market value of the property that the debt secures. Examples seven and eight demonstrate the application of this Revenue Ruling.

**Example 7.** Samantha entered into a loan modification and the lender agreed to reduce the principal balance of the **nonrecourse loan** from \$195,000 to \$175,000 when the value of the home declined. At the time of the loan modification, the fair market value of the home was \$150,000. Samantha's other liabilities consisted of recourse debt of \$80,000 and nonrecourse debt (limited to the FMV of the assets that secures the debt) of \$30,000 and the FMV of other assets was \$70,000. Three years later the lender foreclosed on the property due to Samantha's failure to pay her monthly mortgage payments.

In this situation, \$20,000 (\$195,000 original mortgage minus \$175,000 new mortgage) of Samantha's \$45,000 (\$195,000 original mortgage minus \$150,000 FMV of the property) excess nonrecourse debt is discharged. Only the portion of the excess nonrecourse debt that is discharged is taken into account in determining to what extent Samantha is insolvent.

Samantha's total liabilities are \$280,000 (\$150,000 nonrecourse debt limited to FMV of the home plus \$20,000 excess nonrecourse debt limited to discharged amount plus \$110,000 other recourse and nonrecourse liabilities). Nonrecourse debt (\$175,000) is limited to the fair market value (\$150,000) of the asset that secures the loan, because the taxpayer is not personally liable

and generally not expected to pay any outstanding balance if the property is repossessed. Samantha's total assets right before the discharge are \$220,000 (\$150,000 FMV of the home plus \$70,000 FMV of other assets).

Samantha is insolvent by \$60,000 (\$280,000 total liabilities minus \$220,000 total assets). Since the discharged amount of \$20,000 is less than the extent that Samantha is insolvent, the entire \$20,000 can be excluded from income under IRC §108(a)(1)(B).

**Example 8.** Naomi entered into a loan modification and the lender agreed to reduce the principal balance of the **recourse loan** from \$195,000 to \$175,000 when the value of the home declined. At the time of the loan modification, the fair market value of the home was \$150,000. Naomi's other liabilities consisted of recourse debt of \$80,000 and nonrecourse debt (limited to the FMV of the assets that secures the debt) of \$30,000 and the FMV of other assets was \$70,000. Four years later, Naomi was unable to make her mortgage payments and disposed of the property through a short sale.

The amount discharged by the lender was \$20,000 (\$195,000 original mortgage minus \$175,000 new mortgage amount).

Total liabilities right before the discharge was \$305,000 (\$195,000 recourse debt plus \$110,000 other recourse and nonrecourse liabilities). Nonrecourse debt is limited to the fair market value of the asset that secures the loan, because the taxpayer is not personally liable and not expected to pay any outstanding balance if the property is repossessed.

Total assets right before the discharge was \$220,000 (\$150,000 FMV of the home plus \$70,000 FMV of other assets).

Naomi is insolvent by \$85,000 (\$305,000 total liabilities minus \$220,000 total assets). Since the discharged amount of \$20,000 is less than the extent that Naomi is insolvent, the entire \$20,000 can be excluded from income under IRC §108(a)(1)(B).

In both examples (7 and 8), the taxpayers are able to exclude the entire discharged debt. However, the treatment of the nonrecourse loans changed the amount that the taxpayer is insolvent. In **example 7**, a portion of Samantha's nonrecourse loan was discharged which resulted in an insolvency amount of \$60,000, due to the limitations applied to the nonrecourse loans. In contrast, in **example 8**, Naomi had discharged recourse debt which resulted in an insolvency amount of \$85,000, even though the mortgage loan amounts were identical.

### ***Qualified Farm Indebtedness***

Under IRC §108(a)(1)(C) discharged qualified farm indebtedness after April 9, 1986, may be excluded from gross income. Generally, the exclusion for qualified farm indebtedness allows a taxpayer who is in the business of farming to reduce tax attributes in lieu of recognizing discharge of indebtedness income. However, the taxpayer must first apply the rules for bankruptcy and then insolvency under IRC §108(a)(1)(A) and IRC §108(a)(1)(B), respectively. Taxpayers who have additional CODI after applying the insolvency exclusion can use this exclusion for qualified farm debt.

Under IRC §108(g)(1), a discharge of debt qualifies for the qualified farm indebtedness exclusion only if the discharge is by a creditor who is a qualified person. A qualified person is defined in IRC §108(g)(1)(B) as any federal, state or local government or agency or instrumentality thereof and includes IRC §49(a)(1)(D)(iv) an individual, organization,

partnership, association, corporation, etc. who regularly engaged in the business of lending money, which is not a related person (as defined in IRC §465(b)(3)(C)) with respect to the taxpayer.

Two requirements must be met under IRC §108(g)(2), for indebtedness to qualify as qualified farm indebtedness. First, the indebtedness must have been incurred directly in connection with the business of farming. Secondly, fifty percent or more of the taxpayer's aggregate gross receipts for the three taxable years preceding the taxable year of the discharge, must have been attributable to the trade or business of farming.

In addition, IRC §108(g)(3) states that the excluded income cannot exceed the sum of the adjusted tax attributes of the taxpayer plus the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year of the discharge. Under IRC §108(g)(3)(B), the adjusted tax attributes of the taxpayer are the sum of tax attributes other than bases under IRC §108(b)(2).

The adjusted tax attributes are determined as the net operating loss (NOL) for the year of discharge and any NOL carryover to the year of discharge plus any net capital loss for the year of discharge and any capital loss carryover to the year of discharge plus any passive activity loss carryover from the year of discharge. Add three times the sum of any general business credit carryover to or from the year of discharge and minimum tax credit available as of the beginning of the following year of discharge and foreign tax credit carryover to or from the year of discharge, and any passive activity credit carryover from the year of discharge.

IRC §108(g)(3)(C), defines qualified property as any property used or held in a trade or business or for the production of income. A taxpayer may elect on Form 982 to treat real property held primarily for sale to customers as if it were depreciable property. To the extent, the amount of the discharge exceeds the sum of the relevant amounts, the taxpayer is required to recognize cancellation of indebtedness income.

### **Examination Consideration**

The farm exclusion is NOT an election. Although, Form 982 is used to report the exclusion type, amount of CODI excluded from gross income, and the tax attribute reduction, it is not required to be filed with a tax return for the farm exclusion. Failure to attach a Form 982 to a tax return for the farm exclusion does not prevent a taxpayer from excluding cancellation of debt income from gross income. As such, a taxpayer can present documentary evidence for consideration during an examination. An examiner should gather all necessary documents and develop relevant facts to determine whether a taxpayer meets the farm exclusion.

**Example 9.** Karla has been in the business of farming for the past five years and is neither bankrupt nor insolvent. As of February 1, 2012, she had total debt of \$140,000, total adjusted tax attributes of \$80,000, and total adjusted bases in qualified property as of January 1, 2013 was \$60,000. No other exception or exclusion applied. Karla's qualified creditors discharged the \$140,000 of debt in 2012 and subsequently issued a Form 1099-C. Karla can exclude all \$140,000 (\$80,000 plus \$60,000) of the canceled debt from income.

Rev. Rul. 76-500, 1976-2 C.B. 254 states that "...the amount of the canceled portion of a loan represents a replacement of a portion of a farmer's lost profits and must be taken into account in computing net earnings from self-employment for purposes of the tax on self-employment income". Rev. Rul. 73-408, 1973-2 C.B. 15, held that the canceled portion of an emergency loan granted to a farmer by the Farmers Home Administration was includible in the farmer's

gross income. As such, taxable CODI is reported as other farming income and is subject to self-employment tax.

**Example 10 (Part I of Chapter 4, [Example 23](#)).** Chuck has been engaged in the business of farming for the past four years and worked part-time as a plumber for the past three years. Chuck's creditors discharged \$455,000 of debt related to his farming business in 2012 and subsequently issued a Form 1099-C. Chuck did not file for bankruptcy and he is solvent. Chuck qualified to exclude CODI under the qualified farm indebtedness exclusion.

Other Facts:

- His farming gross receipts for the preceding three years were \$180,000 and gross receipts for the preceding three years from his plumbing business were \$7,500.
- Debt immediately before the discharge was \$258,953.
- A 2012 net operating loss was \$75,433.
- Total adjusted bases in qualified property at the beginning of 2013 was \$350,000.

Two requirements must be met under IRC §108(g)(2), for indebtedness to qualify as qualified farm indebtedness. First, the indebtedness must have been incurred directly in connection with the business of farming. In this example, the discharged debt related to Chuck's farming business.

Secondly, fifty percent or more of the taxpayer's aggregate gross receipts for the three taxable years preceding the taxable year of the discharge, must have been attributable to the trade or business of farming.

Chuck's aggregate farming gross receipts of \$180,000 for the three preceding years is more than fifty percent of aggregate gross income. Fifty percent of \$180,000 is \$90,000 (\$180,000 gross receipts multiplied by fifty percent).

Further, the excluded income cannot exceed the sum of the adjusted tax attributes of the taxpayer plus the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year of the discharge.

In this example, Chuck was discharged of \$455,000 of debt. The amount excluded is limited to \$425,433 (\$75,433 adjusted tax attribute (NOL) plus \$350,000 aggregate adjusted bases of qualified property). Cancellation of debt income reportable in gross income was \$29,567 (\$455,000 discharged debt minus \$425,433 CODI limitation).

Under IRC §108(g)(3), excluded income is limited to \$425,433. The remaining \$29,567 of canceled qualified farm debt should be included as farming income subject to employment tax on the 2012 return, Schedule F, as other income.

More information about farming and agriculture issues can be found in [Publication 225](#) and the [Farmers Audit Techniques Guide](#).

### ***Qualified Real Property Business Indebtedness***

A taxpayer (other than a C Corporation) may elect to exclude CODI from discharged qualified real property business indebtedness under IRC §108(a)(1)(D). An eligible taxpayer must make a valid election on a timely filed return (including extensions), to exclude discharged qualified real property business debt from income, by attaching Form 982 to the tax return. A taxpayer may file a late election if an amended tax return is filed within six months of the due date of the

return (excluding extensions) under Treas. Reg. §301.9100-2. If an election is not made timely or with an amended return filed within six months of the due of the return, a taxpayer must request permission to file a late election.

In PLR 201316009, 2013 WL 1699430, a taxpayer filed a timely individual tax return in year 1. The taxpayer was a 50-percent partner in a LLC that received cancellation of debt income related to qualified real property business indebtedness. The LLC failed to identify the type of cancellation of debt income and the individual's tax preparer treated the CODI as other income. It was not until year 3 when the tax preparers realized that the taxpayer was eligible to exclude cancellation of debt income under the qualified real property business indebtedness exclusion. The taxpayer subsequently filed a request for an extension to file a late election. The IRS allowed the taxpayer to file an amended return in order for the individual to make the election under Treas. Reg. §301.9100-3(c)(1).

An eligible taxpayer can make this election to exclude CODI and reduce the basis of depreciable real property by the amount of discharged qualified real property business indebtedness. To qualify for this exclusion, IRC §108(c)(3)(A) requires that the real property must be "used in a trade or business." Facts and circumstances must be considered in each case. Rental real estate may qualify under this exclusion if the rental rises to the level of a trade or business. However, the following situations may not qualify under this exclusion.

- Generally, a taxpayer who is bankrupt or who is insolvent is not eligible for this exclusion, as shown in Table 2, Coordination of Exclusions, discussed earlier. However, a taxpayer may qualify for more than one exclusion.
- Generally, farm indebtedness does not qualify for the qualified real property business indebtedness exclusion, as shown in Table 2, Coordination of Exclusions, discussed earlier.
- Generally, a rental is not a trade or business. Holding property for the production of rents does not necessarily constitute a trade or business for purposes of IRC 162.

PLR 9426006, 1994 WL 312382 states,

"...a rental of even a single property may constitute a trade or business under various Internal Revenue Code provisions...However, the ownership and rental of real property does not, as a matter of law, constitute a trade or business. *Curphey v. Commissioner*, 73 T.C. at 766 (1980) The issue is ultimately one of fact in which the scope of a taxpayer's activities, either personally or through agents, in connection with the property, are so extensive as to rise to the stature of a trade or business." *Bauer v. Commissioner*, 168 F.Supp. 539, 541 (Ct.Cl.1958).

Qualified real property business indebtedness is defined as indebtedness that meets all of the following requirements:

1. The debt 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.
2. It was incurred or assumed before January 1, 1993, or, if it was incurred or assumed after such date, it is "qualified acquisition indebtedness".
3. It is indebtedness with respect to which the taxpayer makes an election to have it treated as qualified real property business indebtedness.

IRC §108(c)(4) defines qualified acquisition indebtedness as, with respect to any real property used in a trade or business, indebtedness secured by such property and incurred or assumed to acquire, construct, reconstruct or substantially improve such property. Qualified real property business indebtedness can include land used in a trade or business. Qualified real property

business indebtedness includes refinanced debt, but only to the extent that the refinanced debt does not exceed the debt being refinanced.

There are two limitations, (1) the debt in excess of value and (2) the overall limitation on the amount of discharged qualified real property business debt that can be excluded from gross income under IRC §108(c)(2) and further described in Treas. Reg. §1.108-6.

In applying the first limitation, the amount of qualified real property business indebtedness excludible from gross income cannot exceed the excess of the outstanding principal amount of the qualified real property business debt (immediately before the discharge) over the fair market value (immediately before the discharge) of the business real property that secures the discharged debt, less, the outstanding principal amount of any other qualified real property business debt that secures the property immediately before the discharge.

In applying the second or overall limitation, the excluded debt amount should not be more than the aggregate adjusted bases of depreciable real property held immediately before the discharge, (excluding depreciable real property acquired in contemplation of the discharge) reduced by the sum of depreciation claimed for the taxable year that CODI was excluded under this exclusion plus, reductions to the adjusted bases of depreciable real property required under IRC §108(b) (e.g., bankruptcy or insolvency exclusions) for the same taxable year plus, reductions to the adjusted bases of depreciable real property required under IRC §108(g), the qualified farm exclusion, for the same taxable year.

### **Examination Consideration**

The qualified real property business exclusion is an **election** by attaching a Form 982 to a timely filed tax return (excluding extensions) or an amended return filed within six months of the due date of the tax return (excluding extensions). Failure to do so disqualifies the taxpayer from excluding cancellation of debt income from gross income under this exclusion. As such, a taxpayer must make a formal request for a Private Letter Ruling when the taxpayer later discovers that he/she qualifies for this exclusion during an examination. The examiner cannot make the determination when the taxpayer did not make a timely election.

**Example 11 (Part I of Chapter 4, [Example 25](#)).** Peter bought a grocery store in 2005 that he operated as his sole proprietorship. Peter made a \$25,000 down payment and financed the remaining \$250,000 of the purchase price with a bank loan. The bank loan documents indicated that it was a recourse loan, secured by the property. Peter had no other debt secured by that depreciable real property. In addition to the grocery store, Peter owned depreciable equipment and furniture with an adjusted basis of \$76,000.

Peter's business encountered financial difficulties in 2011. In 2012, Peter was approved for a loan modification with the lender and \$25,000 of the outstanding balance of the debt was canceled.

Other facts, immediately before the cancellation of debt include the following:

- Peter was not bankrupt and he was not insolvent
- Outstanding principal balance on the grocery store loan was \$195,000
- FMV of the store was \$172,000
- Adjusted basis of the store was \$227,161
- The bank sent Peter a 2012 Form 1099-C. There was no information in boxes 3, 5, 6 or 7 \$25,000 was reported in Box 2

Before the qualified real property business is considered, Peter must first determine whether he qualifies to exclude CODI under the bankruptcy and insolvency exclusions. In this case, Peter does not qualify for either exclusion and may proceed with the qualified real property business exclusion.

Peter looks to the limitations under the qualified real property business indebtedness exclusion for the CODI of \$25,000. The debt in excess of value limitation was \$23,000 (\$195,000 outstanding loan amount immediately before the discharge minus \$172,000 fair market value of the property). Peter did not have an outstanding principal amount of any other qualified real property business debt secured by the property.

The amount of excluded debt cannot exceed the overall limitation of \$220,286 (\$227,161 aggregate adjusted bases of depreciable real property held before the discharge minus \$6,875 depreciation claimed in the year of discharge). Peter did not have any basis reductions made under IRC §108(b) or IRC §108(g) for the same taxable year.

Peter's CODI exclusion of \$23,000 is limited to the overall limitation of \$220,286. The overall limitation is more than the exclusion limitation amount therefore; \$23,000 can be excluded from Schedule C gross income under the qualified real property business indebtedness exclusion. Peter would report \$2,000 (\$25,000 CODI minus \$23,000 Limitation) as other income on his Schedule C.

Peter would complete Form 982 with a check on line 1d (qualified real property indebtedness exclusion), enter \$23,000 on line 2 (total excluded from gross income), and enter \$23,000 on line 4 (amount of qualified real property business basis reduction). Other income (subject to self-employment tax) of \$2,000 would be reported on Schedule C.

### ***Qualified Principal Residence Indebtedness***

The Mortgage Debt Relief Act of 2007 was enacted to assist taxpayers with their financial difficulties regarding their mortgage debt. This provision generally allows taxpayers to exclude income from the discharge of debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for the relief under IRC §108(a)(1)(E). This provision applies to debt forgiven on or after January 1, 2007 through December 31, 2016 or, with respect to debt discharged after December 31, 2015, are discharged subject to an arrangement that is entered into and evidenced in writing before January 1, 2017.

IRC §108(h)(2) defines qualified principal residence indebtedness as acquisition indebtedness within the meaning of IRC §163(h)(3)(B), except that the limitation on the amount of qualified principal residence indebtedness is \$2,000,000 (\$1,000,000) in the case of a married individual filing a separate return. Acquisition indebtedness is further defined as indebtedness incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer that is secured by the residence and indebtedness incurred in refinancing such indebtedness as long as the refinanced indebtedness does not exceed the original indebtedness.

IRC §108(h)(5) states that a "principal residence" has the same meaning as it does in IRC §121. IRC §121 does not define the term "principal residence", but states that gross income does not include gain on the sale of property if a taxpayer owned and used it as his principal residence at least two of the prior five years (5-year look-back test).

Treas. Reg. §§1.121-1(b)(1) and (2) define the terms "residence" and "principal residence". Under Treas. Reg. §1.121-1(b), whether a property is a taxpayer's principal residence is based

on all of the facts and circumstances, including the taxpayer's use of the property and other factors, including the address listed on the taxpayer's federal and state tax returns, driver's license, and the taxpayer's mailing address.

In 2005 and thereafter, the United States experienced a surge in the number of homeowners losing their principal residences to foreclosures. Legislative intent of IRC §108(a)(1)(E) was to assist homeowners who would have had to otherwise pay substantial amount of tax on cancellation of debt income. As such, the definition of principal residence does not include the 5-year look-back test when determining whether a taxpayer qualifies to exclude cancellation of debt income under the qualified principal residence exclusion in IRC §108(a)(1)(E). In other words, a taxpayer is not required to have owned and used a residence as his/her principal residence for a minimum of two years. However, the examiner should identify the facts and circumstances and other factors to determine whether the residence was in fact the taxpayer's principal residence prior to the foreclosure. The 5-year look-back test ownership and use requirements apply only when determining whether the taxpayer may exclude from income any gain on the sale (including a foreclosure sale) of the residence under IRC §121. See examples 12, 13, and 17, discussed later.

For example, if a taxpayer lived in his principal residence for only a year and then moved out of the residence strictly due to the decline in the value of his home and foreclosure proceedings, the disposition may be considered the taxpayer's principal residence at the time of foreclosure, based on these facts alone.

### **Debt That Does Not Qualify**

The exclusion does not apply if the discharge is due to services performed for the lender or any other reason not directly related to a decline in the home's value or the taxpayer's financial condition. Where the debtor is employed by the lender, and the discharge of indebtedness relates to employment services performed, the discharge will not qualify for the exception. In addition, the exclusion doesn't apply to debt forgiven on second homes, business property, rental property, credit cards, or auto loans. Refer to Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments for more information.

The qualified principal residence indebtedness exclusion only applies to acquisition debt. If a loan is discharged in whole or in part and only a portion of the loan is qualified principal residence indebtedness, the exclusion will be applied only to the part of the loan that is qualified acquisition debt, as determined immediately before the discharge. In other words, the amount of the CODI excluded must be the debt that was used to acquire, construct, or substantially improve the principal residence.

**Example 12.** Jacob owns two residences, one in Arizona, and one in Texas. From 2008 through 2013, he lived in the Arizona residence for 7 months and the Texas residence for 5 months of each year. Both homes were foreclosed and sold by the lender in January 2014. The lender forgave the taxpayer of the outstanding debt balances on both homes. Which home would qualify under the principal residence exclusion?

In the case of a taxpayer using more than one property as a residence, the residence that the taxpayer uses the majority of the time during the year will ordinarily be considered the taxpayer's principal residence. The principal residence will depend on all facts and circumstances. Treas. Reg. §1.121-1(b). In the absence of facts and circumstances indicating otherwise, the Arizona residence is Jacob's principal residence. The CODI from the Texas home would be reported as other income unless he qualified for another exclusion. In addition, he would be eligible for the IRC §121 exclusion of gain from the sale or exchange of the

Arizona residence, but not the Texas residence. Any gain realized from the Texas home would be reported on Form 8949, Sales and Other Dispositions of Capital Assets and Schedule D, Capital Gains and Losses.

**Example 13.** Caroline owns two residences, one in Washington and one in California. During 2009 and 2010, she lived in the Washington residence. During 2011 and 2012, she lived in the California residence. During 2013, she lived in the Washington residence. Caroline's principal residence during 2009, 2010, and 2013 is the Washington residence. Caroline's principal residence during 2011 and 2012 is the California residence. She would be eligible for the IRC §121 exclusion of gain from the sale or exchange of either residence (but not both) during 2013. Theoretically, Caroline would also be allowed to exclude cancellation of debt income under the qualified principal residence exclusion from the same primary residence, but not both.

**Example 14.** Joanne purchased her principal residence property for \$100,000 paying \$20,000 cash and securing a mortgage loan (recourse debt) of \$80,000. When the mortgage balance was \$72,000, Joanne defaulted and the property was sold at foreclosure for \$68,000.

If the liability was discharged before 2007, then Joanne had cancellation of indebtedness income of \$4,000 (\$72,000 mortgage balance minus \$68,000 FMV of the property) and a nondeductible capital loss of \$32,000 (\$68,000 FMV of the property minus \$100,000 adjusted basis of the property). If the liability is discharged after 2006, but before January 1, 2015, Joanne can exclude the cancellation of indebtedness income of \$4,000 per IRC §108(a)(1)(E) and she has a nondeductible capital loss of \$32,000 (\$68,000 FMV of the property minus \$100,000 adjusted basis of the property).

**Example 15.** Because of non-payment of a recourse mortgage, the lender foreclosed on Jack's principal residence and he later received government relocation assistance of \$1,500. At the time of the foreclosure sale, Jack's basis in the home was \$245,000, the home's FMV was \$255,000, and the outstanding amount of mortgage debt (first and second) on the home was \$220,000.

Cancellation of debt income is zero (\$220,000 debt balance immediately before the foreclosure minus \$255,000 the FMV of the property). Peter's realized loss from the foreclosure was \$23,500 (\$220,000 outstanding debt balance plus \$1,500 relocation assistance minus \$245,000 adjusted basis of the property).

The rationale of limiting the amount realized to the debt balance is because Jack did not receive any proceeds from the foreclosure sale. The property was Jack's principal residence. Thus, the disposition would be reported on Form 8949, Sales and Other Dispositions of Capital Assets and Schedule D, Capital Gains and Losses as a nondeductible personal loss.

**Example 16.** Dan acquired his primary residence for \$300,000 in 2004. He refinanced the loan in 2009 for \$320,000 and used \$20,000 to pay off personal credit cards and car loans. In 2011, when the mortgage principal balance was \$290,000, he was unable to make the monthly payments and he did not qualify for any mortgage restructuring programs. The lender ultimately foreclosed on the property in 2013 and issued a Form 1099-A indicating a market value of \$350,000. The foreclosure sale did not occur until 2014 for \$155,000. The taxpayer did not report the disposition on any of his tax returns. The taxpayer's 2013 tax return was selected for examination.

If the loan was nonrecourse, the disposition should have been reported in 2013, the year that the lender foreclosed on the property. The foreclosure ended the taxpayer's financial obligation and ownership. In other words, the foreclosure satisfied the taxpayer's debt.

The amount realized for nonrecourse notes is the greater of the fair market value (FMV) of the property or the outstanding loan amount. The realized gain in 2013 was \$50,000 (\$350,000 FMV of the property minus \$300,000 adjusted basis). Under IRC §121 Dan would not recognize the \$50,000 gain.

The case file should document the facts that led up to the foreclosure and other pertinent information. The disposition of the primary residence should have been reported on Form 8949 even though the loss is not deductible. For more details, see Nondeductible Losses in the Schedule D (Form 1040) Instructions.

Assume the facts are the same except the loan was recourse. Additional facts include that in 2014, the court awarded a deficiency judgment to the lender for \$75,000. The deficiency judgment is the amount of the outstanding loan that the taxpayer is personally liable to pay. The taxpayer was not required to pay any outstanding debt in excess of \$75,000. The lender is not required to file and issue a Form 1099-C until 2015. Dan did not report the disposition on any of his returns or attach a Form 982 for the cancelled debt.

The cancellation of debt income in 2014 was \$60,000 (\$290,000 outstanding debt balance minus \$155,000 foreclosure sale amount (FMV) minus \$75,000 deficiency judgment). Since the loan was recourse, the disposition should be reported in 2014, the year of the foreclosure sale and resolution of the recourse note. The nondeductible loss in 2014 was \$145,000 (\$155,000 FMV minus \$300,000).

Dan had a responsibility to report canceled debt income or exclude canceled debt income from gross income and file Form 982 with his tax return whether or not he received a Form 1099-C. During the examination, the taxpayer stated that he qualified to exclude the entire \$60,000 from gross income under the qualified principal residence exclusion. Dan presented documentation that proved that the foreclosed property was his principal residence and the outstanding loan balance was qualified principal residence indebtedness.

Because the qualified principal residence is not an election, failure to file Form 982 with the return does not prevent the taxpayer from presenting documentation during an examination. Based on the facts and circumstances, the examiner did not make an adjustment to include \$60,000 in gross income.

**Example 17.** Amy signed a recourse loan to purchase her principal residence. Shortly after she purchased the home, she was laid off and unable to pay the mortgage. She subsequently entered into a short sale agreement with the lender and sold the home. This was her principal residence for one year. At the time of the sale, Amy's basis in the home was \$170,000, the home's FMV was \$200,000, and the outstanding amount of the mortgage debt was \$220,000. Amy received \$8,000 for relocation assistance through a Making Home Affordable program.

The cancellation of debt income was \$20,000 (\$220,000 outstanding debt balance immediately before the discharge minus \$200,000 fair market value). Amy's tax preparer excluded the \$20,000 cancellation of debt income from gross income under the principal residence exclusion. A Form 982 was not filed with the tax return.

The gain realized from the disposition was \$38,000 (\$200,000 short sale (FMV) plus \$8,000 relocation assistance minus \$170,000 adjusted basis). The tax preparer excluded the \$38,000 gain under IRC §121.

Amy's tax return was selected for examination. The examiner correctly determined that although, a Form 982 was not filed with the return that Amy qualified to exclude the \$20,000

CODI from gross income under the qualified principal residence exclusion in IRC §108(a)(1)(E). No adjustment was made to this issue.

Although, the property was Amy's principal residence, she did not meet the two out of five year test in IRC §121 and the disposition gain is taxable. The examiner made an adjustment and included the \$38,000 gain in income from the short sale of Amy's principal residence.

## **Other Tax Considerations**

### ***Closing Costs***

An important consideration with respect to refinanced qualified principal residence indebtedness is closing costs. This can also occur with "zero down" first mortgages. Often closing costs are rolled into the loan. The refinanced debt that qualifies is limited to the amount of the old mortgage principal. Therefore, closing costs from the refinancing are not includable in the principal residence debt relief exclusion. They are includable in income, unless the taxpayer qualifies under a different exclusion.

### ***Exclusion of Gain***

In addition to the exclusion of cancellation of debt income, a taxpayer may also exclude any gain recognized from the disposition of their principal residence under IRC §121. Gain can only be excluded on one qualified principal residence every two years under IRC §121(b)(3) and the taxpayer must meet the 2 year out of 5 year rule under IRC §121(a). Note that some taxpayers lost their homes before living in them for two years or the homes were not their principal residence for 2 out of 5 years. Under these circumstances, any gain from the disposition is taxable.

## **Examination Consideration**

The principal residence exclusion is NOT an election. Although, Form 982 is used to report the exclusion type, amount of CODI excluded from gross income, and the tax attribute reduction, it is not required to be filed with a tax return for the principal residence exclusion. Failure to attach a Form 982 to a tax return does not prevent a taxpayer from excluding cancellation of debt income under the insolvency exclusion. As such, a taxpayer can present documentary evidence for consideration during an examination. An examiner should gather all necessary documents and develop relevant facts to determine whether a taxpayer meets the principal residence exclusion.

### ***Audit Techniques***

- If the loan balance is in question, review property records, foreclosure notices, loan statements, loan documents, etc... to determine the loan balance right before the disposition.
- Request the final HUD-1 for the foreclosure, short sale, or deed in lieu of foreclosure. Keep in mind that the taxpayer may not have received the HUD-1. In addition, the final HUD-1 may not identify the total loan balances right before the disposition. It normally will only include the loan amount that the sales proceeds satisfied. Therefore, the loan amounts on the HUD-1 plus the cancellation of debt income may equate to the outstanding loan balance right before the disposition.

- Request the final HUD-1 for short sales, deed in lieu of foreclosures, and loan modifications. There are a few federal, state, local government, and lender incentives that the taxpayer may have qualified for that would appear on the HUD-1. These incentives are generally taxable and included in the amount realized. For example, a taxpayer may receive funds to cover their relocation expenses. This may be listed on the HUD-1 as “relocation assistance”. This amount generally is taxable and should be included in the sales price on Schedule D or Form 4797.
- Identify whether the real estate property was refinanced or if there is a line of credit. Any use of these funds that were not used to buy, build or improve on the principle residence is not acquisition indebtedness and this portion of the CODI may be taxable.

## Chapter 4 – Tax Attribute Reduction

### Reduction of Tax Attributes

When cancellation of debt income is excluded from income under IRC §108(a)(1), tax attributes are generally reduced (but not below zero) by the amount of cancellation of debt income excluded. The reduction in tax attributes defers the tax treatment rather than eliminate CODI. The taxpayer files Form 982 to report the exclusion of CODI and the reduction of tax attributes. If the excluded CODI exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income (Treas. Reg. §1.108-7(a)(2)) as illustrated in Example 22. Each exclusion has its own tax attribute reduction rules that are discussed in this section.

IRC §108(b) prescribes how and in what order tax attributes must be reduced, for the bankruptcy, insolvency, and farm exclusions. The farm indebtedness exclusion requires two calculations to determine the amount to reduce tax attributes. Once specific rules of the qualified real property business exclusions are applied, basis will be reduced in accordance with IRC §108(c) and IRC §1017. See [Table 3](#), Tax Attribute Reduction Rules, discussed later.

IRC §108(b) does not apply to the qualified principal residence exclusion. The qualified principal residence exclusion only requires a reduction in basis (but not below zero) of the principal residence when the taxpayer continues to own the property after debt is canceled (e.g. loan modification) as prescribed in IRC §108(h). See [Table 3](#), Tax Attribute Reduction Rules, discussed later.

Any assets disposed of during the taxable year when debt is discharged are not subject to basis reduction under IRC §108(b)(2)(E), with the exception of the qualified real property business indebtedness exclusion, discussed later. If the sale of an asset gives rise to an unused ordinary or capital loss (e.g., it creates or adds to a net operating or capital loss), that loss is subject to reduction under IRC §108(b)(2)(A) for net operating loss or IRC §108(b)(2)(D) for capital loss carryover.

The basis reductions under IRC §108(b)(2)(E) are accomplished under ordering rules set forth in Treas. Regs. §1.1017-1(a) for bankruptcy and insolvency exclusions. Again, the other exclusions have different basis reduction rules. The ordering rules require a reduction (but not below zero) in the following order, to the extent of excluded cancellation of debt income. The reduction to bases of property is made on the first day of the following year that the taxpayer excluded CODI from gross income (in proportion to adjusted basis):

- Real property used in a trade or business or held for investment (other than IRC §1221(a)(1) real property, held for sale to customers in the ordinary course of business) that secured the discharged indebtedness immediately before the discharge;
- Personal property used in a trade or business or held for investment, but not inventory, accounts receivable, or notes receivable, that secured the indebtedness immediately before the discharge;
- Remaining property used in a trade or business or held for investment, but not inventory, accounts receivable, notes receivable, or IRC §1221(a)(1) real property, held for sale to customers in the ordinary course of business;

- Inventory, accounts receivable, notes receivable, and IRC §1221(a)(1) real property, held for sale to customers in the ordinary course of business; and
- Property not used in a trade or business nor held for investment.
- Reductions in basis on account of the exclusion from gross income of discharge of indebtedness income are not treated as dispositions of the property (IRC §1017(c)(2)).

### ***Election to Reduce Basis First***

In lieu of following the tax attribute reduction ordering rules in IRC §108(b), a taxpayer may make an election under IRC §108(b)(5) to reduce the basis in depreciable property first, before reducing other tax attributes. The taxpayer may elect to apply any amount of the CODI excluded from income to reduce basis. The election to reduce basis first may be made for all exclusions except for the qualified real property business exclusion and the qualified principal residence exclusion. The taxpayer makes an election by attaching Form 982 to their tax return in the year of discharge and completing Part II, line 5. Depreciable property can both be trade or business or held for investment (rental). It can also be real or personal property. The key is that it must be depreciable.

IRC §1017 describes how basis of depreciable property should be reduced. Any excess CODI after basis is reduced is applied in the order or manner prescribed for the specific exclusion, as applicable, and then IRC §108(b). The basis reduction is limited to the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year of discharged debt.

### ***Election to Treat Certain Inventory as Depreciable Property***

As discussed earlier, the basis reductions under IRC §108(b)(2)(E) are accomplished under ordering rules set forth in Treas. Reg. §1.1017-1(a) for bankruptcy and insolvency exclusions. The bases of the fourth type of property reduced are inventory, accounts receivable, notes receivable, and IRC §1221(a)(1) real property, held for sale to customers in the ordinary course of business. IRC §1017(b)(3)(E) allows a taxpayer to make an election to treat certain inventory as depreciable property, which includes real property described in IRC §1221(a)(1). The election is made on Form 982, line 3. The election may be revoked only with the consent of the Secretary. The election is not available for the qualified real property business exclusion. Application of this election is not discussed in this guide.

## **Depreciation Recapture Reductions**

There is no depreciation recapture for IRC §1250 property for which ACRS or MACRS depreciation deductions are computed using the straight-line method under IRC §1017(d). Depreciation taken in excess of straight line depreciation must be recaptured as ordinary income.

Property that is neither IRC §1245 or IRC §1250 property is treated as IRC §1245 property. Any tax attribute, basis reduction for property treated as section 1245 property is treated as if the reduction was from depreciation under IRC §1017(d)(1)(B).

IRC §1245 property is defined as any property which is or has been property of a character subject to the allowance for depreciation provided in IRC §167 and is either personal property, other property, real property, single purpose agricultural or horticultural structure, storage facility, or any railroad grading or tunnel bore.

IRC §1250 property is defined as any real property other than §1245 property which is or has been property subject to the allowance for depreciation provided in IRC §167, for example, rental property. Under a special rule for IRC §1250 property, when determining whether there is excess depreciation for IRC §1250 depreciation recapture, basis reductions under IRC §1017 are ignored (IRC §1017(d)(2)). In other words, excess depreciation is determined without consideration of IRC §1017 basis reduction.

## Summary of Tax Attribute Reduction Rules

Table 3 is a summary of the primary and secondary Internal Revenue Code sections applicable for each exclusion's tax attribute reduction rules. Although, a Form 982 should be attached to a timely filed return to report the type of exclusion(s) and amount of CODI excluded from income, the qualified real property business exclusion is the only exclusion that is an election where a Form 982 is required. Under IRC §108, a taxpayer may make certain elections where a Form 982 or a statement is required to be attached to a timely filed return. For example, a Form 982 is required to make the election to reduce basis first and to make the election to treat certain inventory as depreciable property.

**Table 3. TAX ATTRIBUTE REDUCTION RULES**

<b>Exclusion</b>	<b>Primary Attribute Reduction Rules</b>	<b>Secondary Attribute Reduction Rules</b>	<b>Form 982 Required?</b>
Bankruptcy	IRC §108(b)	IRC §108(d)(8) IRC §1017(b)(2)	No
Insolvency	IRC §108(b)	IRC §1017(b)(2)	No
Farming	IRC §108(g) – First, determine limitations & excludable amount	IRC §108(b) IRC §1017(b)(4) only basis of qualified property is reduced	No
Real Property Business	IRC §108(c)(2) – First, determine limitations & excludable amount	IRC §108(c) basis of depreciable real property IRC §1017(b)(3)	Yes
Principal Residence	IRC §108(h)(1)	none	No
Bankruptcy, Insolvency, & Farming	IRC §108(b)(5) & IRC §1017(a) Election to first reduce depreciable property held at the beginning of the following year of discharge	IRC §108(b)	Yes
All exclusions except, Real Property Business and Principal Residence	IRC §1017(b)(3)(E) Election to treat certain inventory as depreciable property	IRC §108(b)	Yes

Failure to attach a Form 982 to a tax return for the bankruptcy, insolvency, farm, and principal residence exclusions does not prevent a taxpayer from excluding cancellation of debt income from gross income. As such, a taxpayer can present documentary evidence for consideration

during an examination. An examiner should gather all necessary documents and develop relevant facts to determine whether a taxpayer meets the exclusion(s).

Keep in mind that a taxpayer may qualify for more than one exclusion at one time. If that is the case, the exclusion that has precedence is applied first thus, multiple attribute reduction rules may apply. See Examples [24](#) and [25](#).

As stated earlier, IRC §108(b) prescribes the type and order of tax attributes that should be reduced at the beginning of the following year of discharge. Certain tax attributes are reduced dollar for dollar and other tax attributes are reduced by 33 1/3 cents per dollar. As shown in Table 4, *Order and Timing of Tax Attributes*, within the order of reduction, most attributes that exist after the computation of taxable income for the year of discharge are reduced. Other attributes that exist in the beginning of the following year of discharge are reduced.

IRC §108(b)(4) prescribes the ordering rules for tax attributes. IRC §108(b)(4)(B) and (C) prescribe the order of carryovers. Losses in the year of discharge are reduced first and then any carryovers into the year of discharge are reduced. See Table 4, *Order and Timing of Tax Attributes*.

**Table 4. ORDER AND TIMING OF TAX ATTRIBUTES**

<b>Order Reduced – IRC §108(b):</b>	<b>Year Reduced</b>
NOL – current & carryovers	Year of discharge, then oldest year
General business credits	Year of discharge, then oldest year
Minimum tax credit	Following taxable year of discharge
Capital loss carryovers	Year of discharge, then oldest year
Basis in property	Following year of discharge
Passive activity loss & credits	Year of discharge
Foreign tax credit	Year of discharge, then oldest year

*Explanation of Table 4, Order and Timing of Tax Attributes:*

Reductions in tax attributes are made after the determination of tax for the year of discharge. Losses and credits that exist after the determination of tax are reduced first. Carryovers to or from the year of discharge that were not applied in the determination of tax are then reduced. Bases in property that are held on the first day of the taxable year following the year that CODI is excluded are reduced.

For example, a calendar year taxpayer was discharged of debt in year 2 and tax attributes listed in Table 4 existed on January 1st of year 3. On January 1st year 3, the taxpayer would first reduce year 2 net operating loss and then the net operating loss carryover from year 1. See Chapter 4, [Example21](#).

## Bankruptcy, Insolvency, and Farm – Attributes Reduction

Under IRC §108(b)(4)(A), tax attributes are reduced after the determination of tax for the year of discharge. As discussed earlier and in Table 4, *Order and Timing of Tax Attributes*. IRC §108(b) describes the type and order of attribute reduction for the bankruptcy, insolvency, and qualified farm indebtedness exclusions. The farm indebtedness exclusion requires two calculations to determine the amount to reduce tax attributes.

Any reduction of basis arising from the income exclusion under IRC §108(a)(1)(A) in a bankruptcy proceeding must be applied to property other than property that is exempt property for purposes of the bankruptcy proceeding (IRC §1017(c)(1)).

Any basis reduction under IRC §108(b)(2)(E) for the bankruptcy or insolvency exclusion is limited, as demonstrated in Example 20.

Tax attributes are reduced in the following order in accordance with IRC §108(b):

- A. Net operating loss (NOL) is reduced by one dollar for each dollar of excluded canceled debt. First, reduce any current year NOL and then reduce any NOL carryover to the current year in the order of the tax years from which the carryovers arose, starting with the earliest year.
- B. General business credit. Any carryover to or from the taxable year of discharge. A carryover is reduced by 33 1/3 cents for each dollar of excluded canceled debt. For more information on the credit ordering rules, refer to the instructions for Form 3800, General Business Credit.
- C. Minimum tax credit available under IRC §53(b) is reduced by 33 1/3 cents for each dollar of excluded canceled debt as the beginning of the taxable year immediately following the taxable year of discharge.
- D. Net capital loss is reduced by one dollar for each dollar of excluded canceled debt. First, reduce any current year net capital loss and then any capital loss carryover.
- E. Basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year of the discharge.
- F. Passive activity loss and credit carryovers under IRC §469(b) from the taxable year of the discharge. Credit carryovers are reduced by 33 1/3 cents for each dollar of excluded canceled debt.
- G. Foreign tax credit carryovers. Any carryover to or from the taxable year of the discharge for the purposes of determining the amount of the credit allowable under IRC §27. Carryovers are reduced by 33 1/3 cents for each dollar of excluded canceled debt.

Under IRC §108(d)(8), a taxpayer who is discharged of debt in a Chapter 7 or 11 (e.g., bankruptcy) of title 11 of the United States Code to which IRC §1398, Rules relating to individuals' title 11 cases, applies, the estate and not the individual is treated as the taxpayer for discharged debt. Tax attribute reduction is therefore made by the estate and not the individual, except for property that the estate transfers to the individual. If basis reduction is required when the discharge occurs in the final year of a bankruptcy estate, the reduction is made in the basis of assets transferred to the debtor from the estate at the time the property is transferred. No tax affect exists if a bankrupt taxpayer does not have any attributes to reduce at the beginning of the year following the discharge.

## ***Bankruptcy Attribute Reduction Examples***

**Example 18 (Part II of Chapter 3, [Example 5](#)).** Tara owed several creditors and was no longer able to meet her financial obligations. As a result, she filed for Chapter 7 bankruptcy and was granted a discharge of \$174,678 of her debt in 2012. Tara excluded the \$174,678 from taxable income on her 2012 Form 1040 return and attached Form 982 to report the exclusion.

On Form 982 Part II, Tara elected to first reduce basis in depreciable property held on January 1, 2013 by \$160,000, under IRC §108(b)(5). The only depreciable property owned was a residential rental property held for investment. The adjusted basis after the discharge of debt on January 2, 2013, was zero (\$160,000 rental property adjusted basis on December 31, 2012 minus \$160,000 basis reduction on January 1, 2013).

CODI of \$174,678 minus the basis reduction of \$160,000 equals the remaining amount of tax attributes that must be reduced by \$14,678.

The taxpayer elected to reduce basis first, therefore, the next step is to reduce tax attributes in order under IRC §108(b)(2). The tax attributes on January 1, 2013, included a 2012 Net operating loss (NOL) for \$3,000 and a 2012 General business credit carryover for \$58,200.

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount that each tax attribute is reduced. For example, the NOL is reduced to the extent to which the amount excluded from income does not reduce basis, and so on. Under IRC §108(b)(1), the amount excluded from gross income shall be applied to reduce tax attributes.

### **Tax Attributes Reduction on January 1, 2013**

<b>Description</b>	<b>Attribute Reduction</b>	<b>CODI</b>
Remaining CODI 174,678 less 160,000 equals		14,678
Minus 2012 NOL	3,000	
CODI Balance		11,678
Minus 2012 General business credit carryover	11,678	
CODI Balance		0

As shown in the table above, tax attributes are reduced by the amount of cancellation of debt income excluded from gross income. The reduction to the net operating loss is dollar for dollar and the reduction to the general business credit carryover is computed as \$11,678 multiplied by .3333 equals \$3,892.

Tax attribute balances on January 2, 2013, for the 2012 net operating loss was zero (\$3,000 minus \$3,000) and the 2012 general business credit carryover was \$54,308 (\$58,200 less \$3,892). Tara had no other tax attributes subject to reduction under IRC §108(b). Therefore, further attribute reduction is not required. The 2012 Form 982 is completed as shown in the following table.

**2012 Form 982 Parts I and II**

<b>Line Number</b>	<b>Form Line Description</b>	<b>Mark or Amount</b>
Line 1a	Discharge of debt in a title 11 case	Mark an X
Line 2	Total amount of discharged debt excluded from gross income	\$174,678
Line 5	Election to reduce basis first	\$160,000
Line 6	Net operating loss	\$3,000
Line 12	2012 General business credit carryover	\$3,892

**Example 19.** Gary was granted a discharge of \$123,100 debt in bankruptcy court for tax year ending December 31, 2012. Taxable income was \$45,000 before the use of a 2011 net operating loss carryover of \$109,969. Gary qualifies to exclude CODI under IRC §108(a)(1)(A), bankruptcy, and does not elect to reduce basis first. Additional facts are shown below. Under IRC §108(b)(4)(A), taxable income must first be determined to identify the amount and type of attribute to reduce. The 2012 taxable income was zero (\$45,000 taxable income before 2011 NOL carryover minus \$45,000 net operating loss deduction).

Tax attributes that existed on January 1, 2013, were the net operating loss carryover of \$64,969 (\$109,969 minus \$45,000), 2012 general business credit of \$26,624, and a 2012 capital loss of \$31,507.

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

**IRC §108(b) - Tax Attribute Reduction on January 1, 2013**

<b>Description</b>	<b>Tax Attribute</b>	<b>CODI</b>
CODI excluded from income		\$123,100
Minus NOL	64,969	
CODI Balance		\$58,131
Minus 2012 Gen. Bus. Credit	26,624	
CODI Balance		\$31,507
Minus 2012 Capital Loss	31,507	
CODI Balance		\$0

The tax attribute balances on January 2, 2013, for the 2012 NOL carryover was zero (\$64,969 minus \$64,969), the 2012 general business credit was \$17,750 (\$26,624 multiplied by .3333 minus \$26,624), and the 2012 capital loss was zero (\$31,507 minus \$31,507).

IRC §108(b)(4) prescribes the ordering rules for tax attributes. IRC §§108(b)(4)(B) and (C) prescribe the order of carryovers. Tax attributes in the year of discharge are reduced first and then any carryovers into the year of discharge are reduced. See [Table 4](#), *Order and Timing of Tax Attributes*.

## ***Insolvency Attribute Reduction Examples***

**Example 20 (Part II of Chapter 3, [Example 6](#)).** Ashley was unable to pay her recourse mortgage for her second home after her divorce. She entered into a deed in lieu of foreclosure agreement with the lender on October 1, 2012, and was simultaneously forgiven of the outstanding debt. The bank subsequently issued a Form 1099-C for \$50,000 discharged debt. Ashley was insolvent by \$30,260 (\$756,589 total liabilities, includes mortgage of second home, minus \$726,329 total assets,(includes FMV of second home)). The cancellation of debt income reported in gross income was \$19,740 (\$50,000 debt forgiven minus \$30,260 insolvent amount).

On January 1, 2013, Ashley prepared the following worksheet to figure her tax attribute reduction. Tax attributes are reduced (but not below zero) by the amount of CODI excluded from income. Keep in mind that Ashley no longer owned her home as of October 1, 2012.

On October 2, 2012, the bases reduction is limited to \$43,411 (\$590,000 aggregate of bases of the property held by the taxpayer immediately after the discharge (excludes second home) minus \$546,589 aggregate of the liabilities immediately after the discharge (excludes second home)) under IRC §108(b)(2)(E) and IRC §1017(b)(2).

The tax attributes that existed on January 1, 2013, was a 2012 capital loss of \$2,000, basis in property owned (includes purchases of assets) described in Treas. Reg. Treas. Reg. §1.1017-1(a) of \$610,000, and a 2012 passive activity loss of \$19,000.

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

### **Tax Attribute Reduction on January 1, 2013**

<b>Description</b>	<b>Tax Attribute</b>	<b>CODI</b>
CODI excluded from income		30,260
Less 2012 Capital loss	2,000	
CODI Balance		28,260
Less Bases in Treas. Reg. §1.1017-1(a) property	28,260	
CODI Balance		0

Ashley reported \$19,740 of the CODI as other income on her 2012 Form 1040 and excluded \$30,260 from gross income under IRC §108(a)(1)(B), the insolvency exclusion. She attached Form 982 to her return. Form 982 would be completed with a check mark on Form 982 line 1b (insolvency), \$30,260 on line 2 (CODI excluded from income), \$2,000 on line 9 (2012 capital loss), and \$28,260 on line 10a (basis in depreciable and nondepreciable property).

Tax attributes balances on January 2, 2013 included the basis in Treas. Reg. §1.1017-1(a) property of \$581,740 (610,000 minus \$28,260), a 2012 PAL carryover of \$19,000, and a zero balance of the 2012 capital loss (\$2,000 minus \$2,000).

**Example 21.** Constance was unable to make her mortgage payments on her second home and entered into a short sale agreement with the lender. The property was sold on August 5, 2012 and the lender forgave the remaining outstanding debt of \$112,753. Constance excluded cancellation of debt income under the insolvency exclusion.

Additional facts include:

- Insolvent immediately before the discharge by \$120,000
- 2012 Net operating loss of \$63,820
- 2012 Capital loss of \$3,312
- 2011 Capital loss carryover of \$2,970
- Bases in property of \$885,963
- Basis limitation-IRC §1017(b) of \$10,000
- 2012 Passive activity loss of \$97,963

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

#### **Tax Attribute Reduction on January 1, 2013**

Description	Tax Attribute	CODI
CODI excluded from gross income		\$112,753
Minus 2012 Net operating loss	63,820	
CODI balance		48,933
Minus 2012 Capital loss	3,312	
CODI balance		45,621
Minus 2011 Capital loss carryover (unused in 2012)	2,970	
CODI balance		42,651
Minus Basis limitation-IRC §1017(b)	10,000	
CODI balance		32,651
Minus 2012 PAL	32,651	
CODI balance		\$ 0

Constance would complete Form 982 as a check mark on line 1b Insolvency, line 2, CODI excluded of \$112,753, line 6, NOL of \$63,820, line 9, capital loss of \$6,282 (3,312 *plus* 2,970), line 10a, basis of \$10,000, and line 12, 2012 PAL of \$32,651.

The tax attribute balances as of January 2, 2013, included bases in property of \$875,963 (\$885,963 minus \$10,000), a 2012 PAL carryover of \$65,312 (\$97,963 minus \$32,651), a 2012 NOL of zero (63,820 less 63,820), and a 2012 capital loss carryover of zero (6,282 *less* 6,282).

#### ***Other Considerations for Bankrupt or Insolvent Taxpayers***

What happens if a taxpayer is bankrupt or insolvent and does not have any tax attributes to reduce other than personal-use property? If a taxpayer does not have any tax attributes as previously discussed, the basis in personal-use property held at the beginning of the year following the discharge is reduced. Personal-use property would be property not used in a trade or business nor held for investment such as a personal residence, home furnishings, car, etc. Basis reduction limitations prescribed in IRC §1017(b)(2) and Treas. Reg. §1.1017-1(b)(3) apply to bankrupt or insolvent taxpayers. The total basis reduction for all personal-use property is limited to one criterion described under step 1 below. Once the basis limitation is determined, the basis in each personal-use property is reduced in proportion to the total adjusted basis of the personal-use property, described in step 2.

Step 1 is the basis reduction limitation which is the smallest of the bases of personal-use property held at the beginning of the following year of discharge or the amount of canceled non-business debt (other than qualified principal residence indebtedness) that is excluded from

income on Form 982 line 2 or the excess of the total bases of the property and the amount of money held immediately after the cancellation over total liabilities immediately after the cancellation.

Step 2 is the amount from step 1 multiplied by the basis of personal-use property **divided by** the adjusted basis of all personal-use property equals the amount of basis reduction for the respective property. See Example 22 for further clarification.

**Example 22.** Ayden’s second home was foreclosed and the lender forgave \$105,000 of the debt after the sale. She is insolvent by \$90,000 and she did not have any tax attributes other than basis in personal-use property.

Facts developed during the examination revealed that the bases of personal-use property held at the beginning of the year following discharge was \$330,000, the amount of canceled non-business debt (other than qualified principal residence indebtedness) that is excluded from income on Form 982 line 2 was \$90,000, and the excess of the total bases of the property and the amount of money held immediately after the cancellation over total liabilities immediately after the cancellation was \$10,000.

Ayden reduced basis in personal-use property by \$10,000, which is the smallest of the three amounts. In addition, Form 982 is completed with a check box on line 1b (insolvency), \$90,000 on line 2 (amount of discharged debt), and \$10,000 on line 10a (basis reduction of nondepreciable and depreciable property). The basis reduction limited to \$10,000.

Basis in personal-use property follows:

- Principal residence \$300,000
- Furniture \$13,300
- Automobile \$15,200
- Jewelry \$1,500
- Total property bases \$330,000

The basis in each personal property is reduced in proportion to the total adjusted basis as shown in the following table:

**Basis Reduction Calculation**

Description	Allocation	Total
Principal Residence	<i>10,000 multiply by (300,000 divided by 330,000) equals</i>	9,091
Furniture	<i>10,000 multiply by (13,300 divided by 330,000) equals</i>	403
Auto	<i>10,000 multiply by (15,200 divided by 330,000) equals</i>	461
Jewelry	<i>10,000 multiply by (1,500 divided by 330,000) equals</i>	45
Total		10,000

The basis in each personal property before and after the bases reduction is shown in the following table:

<b>Adjusted Bases Balances after Reduction</b>		
<b>Description</b>	<b>Adjusted Basis BEFORE Reduction</b>	<b>Adjusted Basis AFTER Reduction</b>
Principal Residence	\$300,000	\$290,909
Furniture	\$13,300	\$12,897
Auto	\$15,200	\$14,739
Jewelry	\$1,500	\$1,455
Totals	\$330,000	\$320,000

In summary, Ayden would report \$15,000 as other income on Form 1040 line 21. She excludes \$90,000 from gross income. The exclusion is reported on Form 982 as a check mark on line 1b (extent of insolvency), line 2 (excluded CODI) of \$90,000, and line 10a (nondepreciable property) of \$10,000.

In this example, CODI exceeds the sum of the tax attributes that are required to be reduced by \$80,000 (90,000 less 10,000). Per Treas. Reg. §1.108-7(a)(2), no further tax attribute reduction is required and Ayden is not required to include any of the \$90,000 in income.

### ***Qualified Farm Indebtedness – Basis Attribute Reduction***

As discussed earlier, tax attributes under the qualified farm indebtedness exclusion are reduced in the same manner as the bankruptcy and insolvency exclusions under IRC §108(b), except for basis. Only basis of qualified property is reduced under this exclusion. Qualified farm property is defined in IRC §108(g)(3)(C) as any property used or held for use in a trade or business or for the production of income.

IRC §108(b) provides the order in which the taxpayer must reduce tax attributes when qualified farm indebtedness is excluded from income. IRC §1017(b)(4)(A)(i) provides that only qualified property held by the taxpayer is eligible for basis reduction due to the discharge of qualified farm indebtedness. IRC §1017(b)(4)(A)(ii) further provides that the basis of qualified property must be reduced in the following order:

1. Depreciable qualified property.
2. Land used or held for use in the trade or business of farming.
3. Other qualified property.

**Example 23 (Part II of [Example 10](#)).** An overview of the facts from Example 10 is:

- Chuck did not file for bankruptcy and he is solvent.
- \$455,000 discharged debt related to Chuck’s farming business
- \$425,433 CODI limitation
- \$ 29,567 CODI reported in farming gross income

- Tax attributes on January 1, 2013--2012 NOL of \$75,433.
- Chuck did not elect to treat real property held primarily for sale to customers as depreciable property.
- The basis of qualified property is reduced in the following order Depreciable qualified property of \$200,000
- Qualified land of \$135,000
- Other qualified property \$15,000

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

#### Attribute Reduction on January 1, 2013

Description	Tax Attribute	CODI
CODI excluded from gross income		\$425,433
2012 NOL	75,433	
CODI balance		350,000
Minus depreciable qualified property	200,000	
CODI balance		150,000
Minus qualified land	135,000	
CODI balance		15,000
Minus other qualified property	15,000	
CODI balance		\$ 0

All tax attributes had a zero balance on January 2, 2013, after the tax attributes were reduced. The 2012 NOL carryover was zero (\$75,433 minus \$75,433), the depreciable qualified property adjusted basis was zero (\$200,000 minus \$200,000), the qualified land adjusted basis was zero (\$135,000 minus \$135,000), and the other qualified property adjusted basis was zero (\$15,000 minus \$15,000).

### Qualified Real Property Business Indebtedness–Attributes Reduction

As discussed earlier, an eligible taxpayer can make an election to exclude cancellation of debt income under the qualified real property business indebtedness exclusion in IRC §108(a)(1)(D). Under IRC §108(c)(1) the amount of CODI excluded under this exclusion is applied to reduce the basis of the depreciable real property of the taxpayer. The term qualifying real property means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of IRC §108(c)(3).

In applying basis reduction for the qualified real property business indebtedness exclusion, IRC §1017(b)(3)(F) is relied upon and basis reduction must first be made **to the property securing the debt** that is canceled. Treas. Reg. §1.1017-1(c)(1)). Furthermore, if the property is sold/foreclosed in the same year as the debt cancellation, IRC §1017(b)(3)(F) requires that the **basis reduction be made immediately before the disposition**. This will result in section 1250 recapture as ordinary income upon the deemed sale of the property. IRC §1017(b)(3)(F)(iii)).

Bottom line, if a taxpayer is able to exclude CODI under the qualified real property business indebtedness exclusion in IRC §108(a)(1)(D), the taxpayer must first reduce the basis of the

property securing the debt that is discharged. By reducing the adjusted basis of the property, the realized gain from the foreclosure or short sale would be increased (or the loss reduced). The amount of COD income excluded and the section 1250 recapture amount would cancel one another. Thus, the immediate recapture will negate any tax benefit from the CODI exclusion under IRC §108(a)(1)(D).

### ***Recapture Reductions***

- IRC §1245 property is defined as any property which is or has been property of a character subject to the allowance for depreciation provided in IRC §167 and is either personal property, other property, real property, single purpose agricultural or horticultural structure, storage facility, or any railroad grading or tunnel bore. Refer to IRC §1245 for more details.
- IRC §1250 property is defined as any real property other than IRC §1245 property which is or has been property subject to the allowance for depreciation provided in IRC §167, for example, rental real estate property.
- Property that is neither IRC §1245 or IRC §1250 property is treated as IRC §1245 property (IRC §1017(d)(1)(A)).
- Any basis reduction as a result of excluding CODI from gross income is treated as depreciation for IRC §1245 and IRC §1250 property (IRC §1017(d)(1)(B)).
- Depreciation taken in excess of straight line depreciation is recaptured. Under a special rule for IRC §1250 property, when determining whether there is excess depreciation for IRC §1250 depreciation recapture, basis reductions under IRC §1017 are ignored (IRC §1017(d)(2)).

**Example 24.** Michael owns depreciable real estate property used for his retail business. His adjusted basis in the property is \$200,000 (includes bases reductions) before the discharge of debt. The outstanding recourse loan balance is \$180,000. Michael had no other debt secured by this depreciable real property. The retail business incurred a net operating loss of \$18,000 in 2012.

During 2012, Michael lost major customers due to the economy's downturn and he was unable to make the monthly mortgage payments and had to close the store. This was Michael's only business and means of earning a living. The lender foreclosed on the property in 2012 and sold it for \$150,000. The lender issued Michael a Form 1099-C for canceled debt of \$30,000.

Immediately before the cancellation, Michael was insolvent to the extent of \$13,000. He can exclude \$13,000 of the canceled debt from income under the insolvency exclusion. Because of that exclusion, he reduced his NOL by \$13,000.

Michael can elect to exclude the remaining \$17,000 (30,000 minus 13,000) of canceled debt from income under the qualified real property business indebtedness provision. The amount he can exclude is subject to both of the following limitations.

The first step is to determine the debt in excess of value. The maximum amount of CODI that can be excluded from gross income is \$30,000 (\$180,000 outstanding principal loan amount immediately before discharge minus \$150,000 fair market value of property minus zero, the outstanding principal amount of any other qualified real property business debt secured by the property immediately before discharge).

The overall limitation equals \$200,000. The excluded debt shall not exceed the aggregate adjusted bases of depreciable real property held immediately before the discharge, (excluding depreciable real property acquired in contemplation of the discharge) reduced by the sum of certain bases reductions.

In this example, the aggregate adjusted bases of depreciable real property held before the discharge is \$200,000 (includes bases reductions).

Since both limitation amounts (\$30,000 and \$200,000) are more than the remaining \$17,000 of canceled debt, Michael can also exclude the \$17,000 from income. Michael's tax attribute balances are the NOL carryover to 2013 of \$5,000 (\$18,000 minus \$13,000 insolvency exclusion) and the adjusted basis of the retail business property of \$183,000 (\$200,000 adjusted basis immediately before the disposition minus \$17,000 IRC §1017(b)(3)(F) qualified real property business exclusion).

Michael checks the boxes on lines 1b and 1d of Form 982 and enters \$30,000 on line 2. He completes Part II of Form 982 to reduce his basis of depreciable real property by entering \$17,000 on line 4 and entering \$13,000 for the 2012 NOL on line 6. None of the \$30,000 canceled debt is included in his income. The disposition of the business retail store building is reported on Form 4797 as shown in the following table.

**Form 4797**

<b>Description</b>	<b>Amount</b>
FMV of the property	150,000
Add any proceeds received from the foreclosure	0
Minus adjusted basis of the property reduced <i>before</i> the disposition IRC §1017(b)(3)(F)(iii)	183,000
Equals the loss from the foreclosure	33,000

**Example 25 (Part II with facts modified from [Example 11](#)).** Peter bought a grocery store in 2005 that he operated as his sole proprietorship. Peter made a \$25,000 down payment and financed the remaining \$250,000 of the purchase price with a recourse bank loan. Peter had no other debt secured by that depreciable real property, but he owned depreciable equipment and furniture with an adjusted basis of \$76,000. Peter's tax attributes included the basis of depreciable property, a net operating loss, and a capital loss.

In 2012, Peter was approved for a loan modification with the lender and \$25,000 of the outstanding balance of the debt was canceled. Peter qualifies to exclude CODI under IRC §108.

Other facts, immediately before the cancellation of debt include the following:

- Peter was not bankrupt, but he was insolvent to the extent of \$15,000.
- Outstanding principal balance on the grocery store loan was \$195,000.
- FMV of the store was \$170,000.
- Adjusted basis of the store was \$225,926
- The bank sent Peter a 2012 Form 1099-C showing canceled debt of \$25,000.

Peter must apply the insolvency exclusion before applying the qualified real property business indebtedness exclusion. Peter can exclude \$15,000 of the canceled debt from income under the insolvency exclusion. Peter elects to reduce his basis of depreciable property before reducing other tax attributes. The attribute reductions follow.

On January 1, 2013, the bases reduction shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. Peter was insolvent by \$15,000 which is less than the basis limitation of \$301,926 (\$225,926 store plus \$61,000 equipment plus \$15,000 furniture).

Under the election to reduce depreciable property first in IRC §108(b)(5) and Treas. Reg. §1.1017-1(c), property that secured that discharged debt is reduced first. After the basis reduction, Peter's adjusted basis in the store property is \$210,926 (\$225,926 adjusted basis of store minus \$15,000 insolvent amount).

Peter now looks to the limitations under the qualified real property business indebtedness exclusion for the remaining CODI of \$10,000 (25,000 less 15,000) as follows:

The first step is to determine the debt in excess of value. The maximum CODI amount that can be excluded from gross income equals \$25,000 (\$195,000 grocery store's outstanding principal loan amount, immediately before discharge minus \$170,000 fair market value of property less \$0 the outstanding principal amount of any other qualified real property business debt secured by the property).

The second step is to determine the overall limitation. The excluded debt shall not exceed the aggregate adjusted bases of all depreciable real property held before the discharge, (excluding depreciable real property acquired in contemplation of the discharge) reduced by the sum of certain basis reductions. The overall limitation is \$210,926 (\$225,926 aggregate adjusted bases (already reduced by 2012 depreciation) of depreciable real property held before the discharge minus \$15,000 basis reduction made under the insolvency exclusion (IRC §108(b) plus zero basis reduction made under the qualified farm exclusion (IRC §108(g)).

Peter's exclusion is also limited to the overall limitation of \$210,926, the total adjusted basis (determined after reduction for the canceled debt excluded under the insolvency exclusion) of his depreciable real property, he held immediately before the cancellation of debt.

Since both of these limits exceed the \$10,000 of the remaining canceled debt (\$25,000 minus \$15,000), Peter can exclude \$10,000, under the qualified real property business indebtedness exclusion.

In summary, Peter can exclude the entire \$25,000 of canceled debt, \$15,000 under the insolvency exclusion and \$10,000 under the qualified real property business indebtedness exclusion.

Peter would complete Form 982 with a check mark on lines 1b and 1d (insolvency & qualified real property business indebtedness exclusions, respectively), \$25,000 on line 2 (total excluded from gross income), \$10,000 on line 4 (amount of qualified real property business basis reduction) and \$15,000 on line 5 (election to reduce basis first).

## Qualified Principal Residence Indebtedness - Attribute Reduction

IRC Section §108(h)(1) provides that the amount of qualified principal residence indebtedness excluded will be applied to reduce (but not below zero) the basis of the taxpayer's principal residence. Furthermore, IRC §108(h)(1) only requires that the basis of the home be reduced under the qualified principal residence exclusion in the year that debt is discharged. Thus, if the taxpayer enters into a loan modification, the basis of the home is reduced in the same year that debt is forgiven. When the taxpayer ultimately sells the residence, the lowered adjusted basis will be used to compute the gain or loss.

Alternatively, if the home is foreclosed, the taxpayer is not required to reduce the basis of the home, because it is no longer owned and no other tax attributes (e.g. NOL, general business credit, etc.) are reduced. In this situation, any debt forgiven is generally after the repossession and sale of the property.

**Example 26.** Walter received a loan modification for his principal residence and the bank discharged \$52,435 of the debt. The entire nonrecourse debt balance before and after the discharge is qualified principal residence indebtedness. IRC §108(h)(1) states that the basis in the principal residence is reduced by the same amount of debt that is discharged. Walter excludes the entire \$52,435 from income and files Form 982 along with his return. He checks line 1e, enters \$52,435 on line 2, and enters \$52,435 on line 10b (reduce the basis of his principal residence). Three years later Walter sells his home for \$600,000. He purchased his home for \$580,250. His adjusted basis is \$527,815 (\$580,250 minus \$52,435). Walter's gain on the sale is \$72,185 (\$600,000 minus \$527,815) reported on Schedule D, but is excluded from gross income under IRC §121.

**Example 27.** Aaron's principal residence was foreclosed and the lender forgave \$100,000 of the debt after the foreclosure sale. The entire recourse loan was qualified principal residence indebtedness. Aaron excludes the entire \$100,000 from income and files Form 982 along with the return, checks line 1e, and enters \$100,000 on line 2. Aaron does not enter any amount on line 10b (reduce basis of principle residence) because the residence is no longer owned. Furthermore, the taxpayer is not required to reduce the basis in any other assets owned.

**Example 28.** Betty purchased her principal residence in 2004 for \$625,000 through a primary nonrecourse mortgage loan of \$525,000 and a subordinate recourse loan for \$100,000. During 2009 through 2012, she faced financial difficulties and ultimately entered into a short sale agreement with the lenders. On August 20, 2011, the subordinate lender forgave Betty \$100,000. The house eventually sold for \$500,000 on April 15, 2012.

Betty reported the canceled debt on her 2011 Form 982 with a check mark on line 1e, discharge of qualified principal residence indebtedness, \$100,000 on line 2, amount of discharged debt excluded from gross income and \$100,000 on line 10b, reduce basis in principal residence.

The adjusted basis of the principal residence on August 21, 2011 was \$525,000 (\$625,000 cost minus \$100,000 basis reduction). The gain or loss on the short sale of the principal residence reported on the 2012 tax return Schedule D was zero (\$525,000 outstanding nonrecourse loan balance minus \$525,000 adjusted basis).

**Example 29.** Barton received a loan modification in 2013 for his principal residence. The loan qualifies as principal residence indebtedness in IRC §108(h)(2). The lender forgave Barton \$90,000 of the principal recourse loan balance of \$378,569. Barton plans to convert the property to a rental in 2014 and does not want to reduce the basis of his principal residence by the entire \$90,000. Therefore, he elects to apply the insolvency exclusion in lieu of the principal residence exclusion under IRC §108(a)(2)(C). Barton is insolvent by \$50,790 (\$900,000 liabilities immediately before the discharge of debt minus \$849,210 FMV of assets immediately before the discharge of debt). The only tax attribute was a 2013 NOL of \$60,000.

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced under IRC §108(b).

**Tax Attribute Reduction Calculation on January 1, 2014**

<b>Description</b>	<b>Tax Attribute</b>	<b>CODI</b>
CODI excluded from gross income		50,790
Minus 2013 NOL	50,790	
CODI balance		0

Barton is allowed to exclude \$50,790 from gross income to the extent of insolvency. However, he is required to include \$39,210 (\$90,000 debt forgiven minus \$50,790 extent of insolvency) in gross income. The taxpayer is not required to reduce the basis in his principal residence by electing the insolvency exclusion in lieu of the qualified principal residence exclusion. Only the 2013 NOL carryover is reduced to \$9,210 (\$60,000 NOL minus \$50,790 tax attribute reduction).

## Chapter 5 – Rental Real Estate Property

### Introduction

In addition to the rules discussed earlier, if the property is rental real estate property, current and suspended passive losses should be considered. Losses are not allowed unless the disposition is a qualifying disposition under IRC §469(g)(1)(A).

### Qualifying Dispositions under IRC §469(g)

A taxpayer must dispose of his entire interest in the activity in order to trigger the recognition of loss. If he disposes of less than his entire interest, then the issue of ultimate economic gain or loss on his investment in the activity remains unresolved. A disposition of the taxpayer's entire interest involves a disposition of the taxpayer's interest in all entities that are engaged in the activity, and to the extent held in proprietorship form, of all assets used or created in the activity. . . . If the taxpayer has adequate records of the suspended losses that are allocable to that activity, and includes in income the gain (if any) allocable to his entire interest in the activity, such losses are allowed in full upon the disposition. IRS CCA 201415002; 2014 IRS CCA LEXIS 29.

If the taxpayer has a qualifying disposition under IRC §469(g), the current and suspended passive losses on the activity are allowed in full assuming the taxpayer has basis and at-risk. The three tests under IRC §469(g) that must be met as a qualifying disposition are:

1. Disposition must be made to an unrelated party (IRC §267) and
2. The disposition must be fully taxable. All gain/loss must be realized and recognized (a foreclosure is considered a fully taxable disposition) and
3. The property must be disposed of entirely or substantially (Treas. Reg. §1.469-4).

Cancellation of debt income is added to gross rents received on Form 1040 Schedule E, when the debt is related to non-business, non-farm rental of real property. The cancellation of debt income is reported on Form 4835 for certain farming rental activities.

Chief Counsel Advice Memorandum IRS CCA 201415002; 2014 IRS CCA LEXIS 29 provides detailed guidance on the interaction of sections 108 and 469(g) of the Internal Revenue Code. The memorandum addresses whether a foreclosure on real property subject to recourse debt comprising a taxpayer's entire interest in a passive (or former passive) activity qualifies as a fully taxable disposition for purposes of IRC §469(g)(1)(A), where the foreclosure triggers cancellation of indebtedness (COD) income that is excluded from gross income under IRC §108(a)(1)(B).

Chief Counsel concluded that a foreclosure on real property subject to recourse debt comprising the taxpayer's entire interest in a passive (or former passive) activity is a fully taxable transaction for purposes of IRC §§1001 and 469(g)(1)(A), regardless of whether any CODI from the cancellation of recourse debt is excluded under IRC §108(a)(1)(B). Thus, the losses from the activity are treated as not from a passive activity under IRC §469(g)(1)(A). Additionally, these losses are not reduced by any excluded CODI under IRC §108(b)(2)(F).

Multiple examples are provided in this CCA to illustrate the interaction of sections 108 and 469(g) of the Internal Revenue Code. For example, Taxpayer A has disposed of the property in a fully taxable transaction under IRC §1001 and realizes and recognizes \$25,000 of gain on the foreclosure. Thus, the transaction is a fully taxable transaction for purposes of IRC §469(g)(1)(A), and the \$100,000 of suspended passive losses are treated as losses not from a passive activity under IRC §469(g)(1)(A). Additionally, Taxpayer A may exclude the \$75,000 CODI from the cancellation of the recourse mortgage under IRC §108(a)(1)(B) because A is insolvent to the extent of \$200,000.

Taxpayer A does not reduce the \$100,000 of non-passive losses by the \$75,000 CODI excludable under IRC §108(a)(1)(B). Under IRC §108(b)(2)(F) any CODI from the taxable year of the discharge reduces any passive activity loss and credit carryover of the taxpayer under IRC §469(b) from the year of the discharge. However, under IRC §108(b)(4), reductions to tax attributes required by IRC §108(b) are made after determination of tax for the year of discharge.

In this case, in determining Taxpayer A's tax for the year of the discharge, all previously suspended losses under IRC §469(b) are freed-up and fully allowable upon the taxable foreclosure. Therefore, there are no remaining IRC §469(b) suspended loss carryovers that are reduced under section IRC §108(b)(2)(F).

Revenue Ruling 92-92, 1992-2 C.B. 103 states that, "For purposes of section 469 of the Code, COD income is characterized as income from a passive activity to the extent that, at the time the indebtedness is discharged, the debt is allocated to passive activity expenditures". Any amount of the debt that was not used for passive activities is allocated to nonpassive activities.

## **Disqualifying Dispositions under IRC §469(g)**

When a disposition is non-qualified, the current and suspended passive losses on the activity remain on Form 8582 until passive income is reported.

The following do not qualify as fully taxable dispositions (not an exhaustive list):

- Abandonment (qualifying disposition if abandonment rules are met in IRC §165).
- Bankruptcy which has not been finalized; IRC §1398(f)(1), Treas. Regs. §§1.1398-1(c) and (d)(1).
- Related party transfers.
- Rental property converted to personal use.
- Transfer due to divorce (treated as gift; IRC §469(j)(6) & §1041(b)).
- Foreclosure of a property with recourse debt where the foreclosure sale has not occurred. This is not a qualifying disposition under IRC §469(g) and any losses (disposition or suspended operational) are not currently deductible.
- Loss on foreclosure of a rental property where the taxpayer has aggregated rentals. Disposition of one rental is not "complete" under IRC §469(g). In years that a taxpayer is NOT a real estate professional, the election under Treas. Reg. §1.469-9(g) is not binding.

## Depreciation Recapture

There is no depreciation recapture for IRC §1250 property for which ACRS or MACRS depreciation deductions are computed using the straight-line method. Depreciation must be recaptured if straight-line method was not used. The recapture amount is treated as ordinary income.

Depreciation recapture for IRC §1250 property generally is the lesser of the additional depreciation or the excess of the amount realized (in the case of a sale, exchange, or involuntary conversion) or the fair market value of such property (in the case of any other disposition), over the adjusted basis of such property.

Additional depreciation is the depreciation claimed or for property held more than one year, the excess of the depreciation actually claimed over the amount that would have been claimed had the straight-line method been used.

*The basis reduction special rule for depreciation* is determined before any basis reduction. Basis reductions, when CODI is excluded from income, are treated as depreciation for purposes of the depreciation recapture provisions, IRC §1017(d)(1)(B), even if the property otherwise would not be subject to those provisions, IRC §1017(d)(1)(A).

## Character of Property at Disposition

IRC §1221 provides in part that the term capital asset means property held by the taxpayer (whether or not connected with his trade or business) but does not include property, used in a trade or business, of a character which is subject to the allowance of depreciation provided in IRC §167.

IRC §1231(b)(1) provides in part that the term “property used in a trade or business” means property used in a trade or business, of a character which is subject to the allowance of depreciation provided under IRC §167, held for more than 1 year.

The disposition of investment property, second home, vacation home, and personal residence are all reported on Schedule D. The disposition of rental real estate property that is not a trade or business is also reported on Schedule D. The disposition of rental real estate property that is a trade or business is reported on Form 4797.

## Lease with Option to Buy Property

If a rental agreement gives the tenant the right to buy the rental property, the payments received by the lessor under the agreement are generally rental income. If the tenant exercises the right to buy the property, the payments the lessor receives for the period after the date of sale are considered part of the selling price.

**Example 30.** Martha operated a Schedule C business as a divorce attorney and she is not a real estate professional. In 2005, she took out a recourse loan for \$800,000 and purchased an apartment building as an investment. A property management company managed the property. During 2008 through 2010, some of the tenants moved out and others were evicted when they stopped paying rent. In 2009, Martha applied for a loan modification that was declined due to the low rents. In 2010, she depleted her savings and was unable to pay the mortgage, therefore, the lender foreclosed on the property in 2012. The property was sold in 2012 for \$460,050 and Martha was issued a Form 1099-C with a forgiveness of debt of \$189,950.

Immediately before the foreclosure, the recourse loan balance was \$650,000, the FMV of the apartment building was \$460,050, adjusted basis was \$704,545, and suspended passive losses were \$65,364.

Martha's 2012 cancellation of debt income is \$189,950 (\$650,000 outstanding loan balance minus \$460,050 FMV). Martha's rental real estate income reported on 2012 Schedule E is \$74,586 (\$50,000 gross rents plus 189,950 other rental income, CODI, minus \$100,000 rental expenses minus \$65,364 prior years' passive losses).

Martha's realized loss from the foreclosure sale of the apartment building in 2012 was \$244,495 (\$460,050 amount realized (FMV) minus \$704,545 adjusted basis add zero depreciation recapture in excess of straight line).

Martha would report \$189,950 of CODI on Schedule E in 2012 as additional rent and she would report the disposition loss of \$244,495 on Schedule D. The capital loss deduction would be limited.

**Example 31.** Charlie owned and rented a single family residence that he used in his business as a real estate professional. He did not make the election under Treas. Reg. §1.469-9(g) to group his rental properties. He purchased the residence in 2000 for \$480,000. Later, he refinanced the recourse loan and received \$30,000 that was used to make improvements on the property. In 2012, the outstanding loan balance was \$470,000 and Charlie faced difficult health and financial challenges and returned the property to the lender through an approved deed in lieu of foreclosure agreement. Although, a Form 1099-C was not issued, the lender forgave \$20,000 in 2012 according to the agreement. The home was sold in 2013. Charlie was insolvent by \$65,000.

At the time of the deed in lieu of foreclosure agreement, the fair market value was \$450,000, adjusted basis was \$425,000 and suspended passive losses were \$35,364. Although, a Form 1099-C was not issued, *Frazier v. Commissioner* 111 T.C. 243, 246 (1998), will be relied upon and \$20,000 is income from the discharge of indebtedness per IRC §61(a)(12).

However, the entire \$20,000 of cancellation of debt income is excluded from income under the insolvency exclusion. The insolvency exclusion takes precedence over the qualified real property business exclusion.

Charlie's recognized ordinary gain for the deed in lieu of foreclosure disposition reported on Form 4797 is \$25,000 (\$450,000 FMV minus \$425,000 adjusted basis add zero depreciation recapture in excess of straight line). Although, the loan is recourse, the outstanding loan balance was resolved through the deed in lieu of foreclosure agreement. The outstanding recourse loan was resolved despite any future sale of the property.

Passive losses are released upon the disposition of the property in 2012, the year that the deed in lieu of foreclosure agreement is made and the resolution of the outstanding recourse loan balance is made. Charlie's passive losses from this rental are \$45,795.

The disposition of the property is a qualifying disposition under IRC §469(g). The disposition is reported on Form 4797 in Part III. Charlie is also allowed to exclude \$20,000 CODI under IRC §108(a)(1)(B) and deduct all passive losses of \$45,795 incurred from the property.

Charlie is required to reduce tax attributes owned on January 1, 2013 by \$20,000, in the order identified in IRC §108(b) under the insolvency exclusion. By excluding CODI, Charlie has essentially deferred any tax associated with the excluded CODI amount by reducing any tax attributes. Under IRC §108(b)(4)(A) attributes are reduced after taxable income is determined. Tax attributes owned on January 1, 2013 are an NOL carryover for 2012 of \$5,000, a 2011 NOL carryover of \$3,000, and a 2012 capital loss carryover of \$12,000. The tax attribute reductions are shown in the following table.

Note: The following presentation of tax attribute reduction is not meant to imply that CODI is reduced, but only used to demonstrate the amount of tax attributes reduced. Under IRC §108(b)(1) the amount excluded from gross income shall be applied to reduce tax attributes.

#### Tax Attribute Reduction on January 1, 2013

Description	Tax Attribute	CODI
CODI		\$20,000
Minus 2012 NOL carryover (2012 F. 982 line 6)	5,000	
CODI Balance		15,000
Minus 2011 NOL carryover (2012 F. 982 line 6)	3,000	
CODI Balance		12,000
Minus 2012 Capital loss carryover (2012 F. 982 line 9)	12,000	
CODI Balance		0

In summary, CODI excluded from 2012 rental income under the insolvency exclusion is \$20,000 and the January 2, 2013 tax attribute balances are zero (\$5,000 2012 NOL minus \$5,000 NOL tax attribute reduction), zero 2011 NOL (\$3,000 2011 NOL minus \$3,000 tax attribute reduction), and zero 2012 capital loss carryover (\$12,000 capital loss carryover minus \$12,000 tax attribute reduction).

Because the facts and circumstances of each taxpayer may be unique, the passive rules could be applied slightly differently in every examination. Refer to the [PassiveActivityLossAudit TechniqueGuide](#) for a complete discussion on passive activity loss activities or contact a Passive Activity Loss Technical Advisor.

## Rental Audit Strategies

- When CODI, Form 4797 gain/loss or Schedule D gain/loss, and Schedule E gain/loss for all years are netted, you arrive at an overall gain or loss. If this is a loss, ask yourself whether the taxpayer is "poorer" by that amount. If the taxpayer could not afford to sustain that loss then how were the losses funded (e.g., other debt, current year income, other assets)?

- Sometimes taxpayers attempt to convert their principal residence into rental real estate property right before it forecloses and deduct losses. A temporary conversion may not be a true rental activity and loss from the foreclosure would be a non-deductible personal loss. In addition, expenses (e.g., property insurance) would generally be non-deductible personal expenses. It is important to ascertain the facts and circumstances surrounding the reasons for converting the residence to a rental to determine if it was a principal residence, second home or rental property. In *MaDan v. Commissioner*, (T.C. Memo. 1986-7), the petitioners listed their vacant home with three different realtors as “For Sale or Rent.”. The court ruled, “even if exclusively for rent would not be sufficient to establish a profit motive”. Whereas, in *Sherlock v. Commissioner*, (T.C. Memo. 1972-97), the court held that a bona fide intention to rent the vacant residence was converted for the production of income even though, it was never rented. One factor the court relied upon was the taxpayer’s willingness to accept low rent.
- What efforts did the taxpayer make to rent the property? Has the taxpayer provided any documentation of the time spent attempting to the rent the property? Has the taxpayer provided copies of advertisements, listing agreements or other evidence that the property was in fact held out for rent?
- Insurance policies. This should reflect if the property is a rental, personal residence, vacant investment, etc.
- If applicable, how was the property taxed? For real estate property taxes, what is the taxpayer telling the local assessor as to the use of the property? Rental? Vacant? Personal?
- Non-issuance of a Form 1099-C does not relieve a taxpayer of their responsibility to include CODI in income. Identify all loans on the property through internal records and/or property records. All loans should be considered in the CODI and gain/loss calculations. Review internal records from one or two years prior to the foreclosure to identify other debt associated with the foreclosed property. The taxpayer may not have a Form 1098 issued for interest paid in the year of foreclosure, because they made no payments.
- Consider state foreclosure laws of where the property is located. State laws govern foreclosure actions by the lender which will determine the date of sale.

## Chapter 6 - Abandonments

### Tax Consequences of Abandonments

Abandonment is treated as an exchange of property when the owner gives up possession and use of the property voluntarily and permanently to the lender, with the intention of ending his/her ownership and does not pass it on to anyone else. Abandonment may lead to foreclosure proceedings in order for the lender to obtain legal possession of the property. Abandonment is different from a voluntary conveyance such as a deed in lieu of foreclosure. Generally, the lender and the homeowner enter into a deed in lieu of foreclosure agreement where the transaction is treated as an exchange of property to satisfy a debt.

Whether abandonment has occurred or not is determined by a review of all the facts and circumstances. Intent to abandon the property by affirmative acts should be considered to determine whether abandonment occurred. For example, permanently moving out and mailing the keys to the lender can be indicators of the intent to abandon the property. A lender is required to issue a Form 1099-A when the lender determines that property has been abandoned.

The tax consequences depend on whether the debt is recourse or nonrecourse. If the amount realized is more than the adjusted basis, then a gain is realized. If the adjusted basis is more than the amount realized, then a loss is realized. The character of the loss depends on the character of the property. For example, no loss is allowed for abandonment of a personal residence, but a loss from an abandoned business property, rental property, or investment property may be allowed.

If the debt is nonrecourse, a sale or exchange is reported in the year the property is abandoned. If the debt is recourse, then the gain/loss is not reported until the year that foreclosure sale is completed. The IRS has seen that the Form 1099-A may be issued several months or years after the taxpayer has actually abandoned the property. The disposition is not reported until the lender takes action on the property and possibly against the taxpayer within state law timeframes.

The court in *George v. United States*, 1996 WL 437532 (D. Colo. 1996), stated, “[T]he worthlessness and abandonment arguments, however, are inapplicable to recourse debts as a matter of law. Property that secures a taxpayer's recourse obligation is not worthless prior to foreclosure. *Commissioner v. Green*, 126 F. 2d 70, 72 ( 3d Cir. 1942) (“where, as here, the taxpayer is liable for the debt, interest and taxes by virtue of the mortgage or the bond thereby secured, the property continues until foreclosure sale to have some value which, when determined by the sale, bears directly upon the extent of the owner's liability for a deficiency judgment.”) Likewise, property that secures a taxpayer's recourse obligation may not be considered abandoned for purposes of a loss deduction prior to foreclosure. *Daily v. Commissioner*, 81 T.C. 161 (1983) (an attempt to abandon property subject to recourse debt does not result in a deductible loss), *aff'd*, *Daily v. C.I.R.*, 742 F.2d 1461 (9th Cir. 1984); *Middleton v. Commissioner*, 77 T.C. 310, 323 (1981) (“at least one court has held that the abandonment of property subject to a recourse debt does not result in loss until the foreclosure sale because, since the possibility of deficiency exists, the amount of the loss cannot be fixed until the sale takes place.”), *aff'd*, *Middleton v. Commissioner*, 693 F.2d 124 (11th Cir. 1982).”

Completion of a foreclosure is determined by state law. When the year of disposition is in question, examiners should seek advice from their local counsel to determine when a foreclosure is complete.

**Example 32.** In 2007, Diana purchased her principal residence for \$200,000. She borrowed the entire purchase price through a recourse loan. In 2011, Diana's employer faced financial difficulties and reduced employees' salaries which caused a financial hardship on Diana and she was unable to meet her financial obligations. The loan balance on her home was \$185,000 and the FMV declined from \$250,000 to \$150,000. Diana decided to abandon her home, moved her belongings out, and mailed the keys and garage door opener to the lender on August 1, 2011. The bank eventually foreclosed and sold the home in 2012 and issued a Form 1099-C.

Because Diana is personally liable for the debt, she does not report a gain or loss, or CODI in 2011 when she abandoned the home, but in 2012 when the disposition was completed. The affirmative acts taken by Diana by permanently moving out and mailing the keys to the lender indicate her intent to abandon the home, but the lender did not recognize the abandonment until 2012 when the lender foreclosed on the property.

**Example 33.** In 2005, Ruby purchased a second home for \$315,000. She borrowed the entire purchase price through a nonrecourse loan. In 2011, the value of her property declined to \$289,000 and she was able to obtain a loan modification. The lender forgave \$26,000, the difference between the outstanding loan amount and the current FMV of the property. In 2012, Ruby was unable to make the monthly payments and abandoned the property. The lender did not become aware that the property was vacant until 2013 and issued a Form 1099-A. The lender eventually sold the property in a foreclosure sale in 2014.

Ruby does not meet any of the exclusions in IRC §108(a)(1). Therefore, she reported the entire \$26,000 discharged debt as other income on line 21 of her 2011 Form 1040 tax return. Because Ruby was not personally liable for the note, she would report the disposition in 2013, when the lender released her from legal responsibility of the property and note.

As indicated in the examples above, the dispositions were reported in different years. In Example 32, the loan was recourse and the taxpayer was not required to report the disposition until the year that the foreclosure sale was complete. The sale determined the deficiency amount. In some cases, a lender may choose to forgive a portion or the entire amount of the deficiency. Depending on state law and the manner of foreclosure action taken, the taxpayer possibly would be responsible to pay back a portion or the entire deficiency balance once the lender obtains a deficiency judgment.

Since the loan was nonrecourse in Example 33, the disposition is reported in the year that the lender acknowledges that an abandonment occurred through the issuance of a Form 1099-A. Repossession of the property by the lender satisfied the debt.

## Chapter 7 – Form 1099-A and Form 1099-C

### Background

A lender must follow the reporting regulations that determine when a Form 1099-A and/or Form 1099-C are issued to the borrower. Treas. Reg. §1.6050P-1 governs the information reporting for discharges of indebtedness by certain entities. The instructions to Form 1099-A and Form 1099-C provide an overview of these rules.

A debt is deemed to be discharged for information reporting purposes only upon the occurrence of an identifiable event specified under Treas. Reg. §1.6050P-1(b)(2), whether or not an actual discharge has occurred on or before the date of the identifiable event. See Treas. Reg. §1.6050P-1(a)(1).

An identifiable event under Treas. Reg. §1.6050P-1(b)(2)(i)(H) has occurred during a calendar year if a creditor has not received a payment on an indebtedness at any time during a testing period (as defined in Treas. Reg. §1.6050P-1(b)(2)(iv)) ending at the close of the year. The testing period is a 36-month period increased by the number of calendar months during all or part of which the creditor was precluded from engaging in collection activity by a stay in bankruptcy or similar bar under state or local law. The presumption that an identifiable event has occurred may be rebutted by the creditor if the creditor (or a third-party collection agency on behalf of the creditor) has engaged in significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year, or if facts and circumstances existing as of January 31 of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged. Treas. Reg. §1.6050P-1(b)(2)(iv) further states that, significant, bona fide collection activity does not include automated mailings, but does include a lien against the debtor. Under Treas. Reg. §1.6050P-1(b)(2)(i), identifiable events, in general, are summarized below:

- A. A discharge of indebtedness under bankruptcy;
- B. A cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or State court;
- C. A cancellation or extinguishment of a debt upon the expiration of the statute of limitations for collection of a debt;
- D. A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditors right to pursue collection of the indebtedness (e.g., non-judicial foreclosures in some states);
- E. A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- F. A discharge of debt pursuant to an agreement between an applicable entity and a debtor, to discharge indebtedness at less than full consideration (e.g., short sale);
- G. A discharge of debt pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt; or
- H. In the case of an entity described above in (A) through (C), the expiration of the non-payment testing period.

The first seven identifiable events are specific occurrences that typically result from an actual discharge of indebtedness. The eighth identifiable event, the expiration of a 36-month non-payment testing period, may not result from an actual discharge of indebtedness. Due to

debtors' confusion regarding whether the receipt of a Form 1099-C represented cancellation of debt income under the 36-month non-payment testing period, the Treasury Department and IRS issued Notice 2012-65(2012-52 IRC 773 (Dec. 27, 2012)), and requested comments from the public. Several commentators recommended either the removal or revision of the 36-month rule.

The Treasury Department and IRS agree that the information reporting should generally coincide with the actual discharge of a debt. The Department of the Treasury and the IRS are concerned that the 36-month rule creates confusion for taxpayers and does not increase tax compliance by debtors or provide the IRS with valuable third-party information that may be used to ensure taxpayer compliance. Consequently, in October 2014, the IRS issued proposed regulations to remove the rule that a deemed discharge of indebtedness for which a Form 1099-C, Cancellation of Debt must be filed occurs at the expiration of a 36-month non-payment testing period. The proposed regulations will affect certain financial institutions and governmental entities. See 79 FR 61791-01, 2014 WL 5144724 (F.R.).

## Examination Considerations

Generally, the Service may rely on the Form 1099-A and Form 1099-Cs that are issued to taxpayers. Nevertheless, as previously discussed, the issuance of a Form 1099-C solely due to the 36-month testing period may create challenges during the examination. Secondly, as discussed later, an examiner may encounter inaccurate forms. Sometimes, a taxpayer is not issued a Form 1099-A or C on subordinate loans or the taxpayer may not be issued a Form 1099-C on either loan. This does not relieve the taxpayer from reporting the CODI.

The determination of whether discharge of indebtedness has occurred is factual and often the subjective intent of the creditor as manifested by an objectively identifiable event (*Kleber v. Commissioner*, T.C.Memo. 2011-233 at \*3). The issuance of a Form 1099-C is an identifiable event, but it is not dispositive of an intent to cancel indebtedness. For example, in *Kleber v. Commissioner*, *supra*, although the creditor issued the Form 1099-C for the debtor-taxpayer's 2006 tax year, the court found that the discharge of the taxpayer's indebtedness had occurred during her 2002 tax year. Therefore, the Service can assert that a taxpayer's indebtedness has been discharged for the tax year it became clear that a debt would never be repaid, even if the creditor did not issue a Form 1099-C for that year.

The court decided in *Rinehart v. Commissioner* (T.C. Memo. 2002-71) that although Ms. Yeager did not receive a Form 1099-C, the facts led the court to believe that the debt was forgiven and this amount should have been included in income. The court relied on *Cozzi v Commissioner*, 88 T.C. 435, 455 (1987) and *Vaughn v Commissioner*, T.C. Memo. 1992-317, *affd.* without published opinion 15 F.3d 1095 (9th Cir. 1993) and stated,

“When it becomes clear that a debt will never have to be paid, such debt must be viewed as having been discharged, creating income to debtor, and receipt of Form 1099-C from the lender is not determinative...Non receipt of a Form 1099 does not convert taxable income into nontaxable income.”

It is important to identify all loans on the property to determine the correct gain or loss and CODI. A review of property information, county recorder documents, Forms 1099 (e.g., including prior and subsequent years of examination), Schedule A mortgage interest, and/or loan documents should be made.

The following facts and circumstances should be considered to determine whether the taxpayer has cancellation of debt income when a taxpayer is not issued a Form 1099-C:

- Identification of whether the loan was recourse or nonrecourse.
- The sale was completed.
- Lender was awarded a deficiency judgment.
- Collection activity taken against the taxpayer other than phone calls and letters.
- Governing state law of where the property is located.

When the real estate market crashed there were several news stories about taxpayers who were not aware of the tax consequences of their foreclosed property, especially if they did not receive a Form 1099-C. State foreclosure laws govern foreclosure proceedings and actions that can be taken after a foreclosure. For example, if a lender pursues a non-judicial foreclosure proceeding, the lender will not be allowed to pursue a deficiency judgment in some states. Therefore, if the taxpayer was not issued a Form 1099-C, it is important to understand the governing state law where the property is located and the actions taken by the lender to determine the CODI amount, if any. Facts and circumstances will determine when the cancellation of debt should be reported. *Kleber v Commissioner*, T.C. Memo. 2011-233, provides guidance on the application of the rules in Treas. Reg. §1.6050P-1.

In light of IRC §6050P, a question arises as to whether debt is discharged for purposes of IRC §§ 61(a)(12) and 108 when a borrower has not made a mortgage payment for at least 36 months. Whether a debt has been discharged is dependent on the substance of the transactions (*Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987)). The moment it becomes clear that a debt will never be repaid, the debt must be viewed as having been discharged. The test for determining such moment requires a practical assessment of the facts and circumstances relating to the likelihood of repayment. Any “identifiable event” which fixes the loss with certainty may be taken into consideration (*United States v. S.S. White Dental Mfg. Co. of Pennsylvania*, 274 U.S. 398 (1927)). The court stated that the mere fact that a mortgagor has not made a payment for 36 months does not mean that the debt has been discharged.

**IRC §6050P and its regulations do not apply for determining whether the debt has been discharged for purposes of IRC §§61(a)(12) and 108.** The limitation to eight identifiable events and the rebuttable presumption for a 36-month non-payment period under Treas. Reg. §1.6050P-1(b) apply only for purposes of determining the creditor’s obligation to issue a Form 1099-C, Cancellation of Debt. For purposes of IRC §§61(a)(12) and 108, the determination whether debt has been discharged requires a practical assessment of the facts and circumstances relating to the likelihood of payment.

If audit adjustments are made to include CODI, oral testimony from taxpayers may not be enough factual development to support an adjustment, especially if the case is unagreed. In some states, the lender will publicize the foreclosure notice and record the notice of default with the County Recorder’s office. The case file should include documentation to support the Government’s position. An explanation of each supporting document should be addressed to strengthen the Government’s position. For example, a copy of the deed or closing escrow documents will indicate dates, amounts, any monies given to the seller (homeowner) which are needed for the calculation of the gain/loss.

A Form 1099-A is issued when there is an identifiable event. For example, the date when the lender becomes aware the property was abandoned or the date of the foreclosure, short sale or deed in lieu of foreclosure. A Form 1099-C will be issued when the property is sold, in a

foreclosure sale, for example, and the lender discharges some or all of the outstanding debt. A chart with the identifiable codes is located in Publication 4681.

**Example 34.** Marion's property was foreclosed in 2010 and the lender issued a Form 1099-A. The lender did not sell the property until 2013 and issued a Form 1099-C at that time. The year of the disposition would depend on the 1) type of loan and 2) state law of where the property is located.

## **Inaccurate or Questionable Forms 1099-A and 1099-C**

Audit techniques are identified below when a Form 1099-A or Form 1099-C is issued with questionable information. Common situations follow:

### ***Form 1099-C Box 2. Amount of Debt Discharged***

Total debt includes total amount owed to the lender, including stated principal, stated interest, fees, penalties, administrative costs, and fines. Prior to 2014, the IRS instructions for Forms 1099-A and 1099-C instructed the filer not to enter any amount the lender received in satisfaction of the debt by means of a settlement agreement, foreclosure sale, etc...

Since there is a possibility that this amount does not include any consideration received, it may create a problem in identifying the actual amount of the discharged debt for tax purposes. For example, a foreclosure sale resulted in discharge recourse debt of \$30,000. However, the lender entered \$50,000 in Box 2 which does not include consideration received from the foreclosure sale.

### **Audit Technique**

The loan documents or last mortgage statement or settlement agreement letter (ie; short sale) and closing escrow documents along with the Form 1099-A and/or Form 1099-C may help to determine the loan balance and amount forgiven at the time of the disposition.

### ***Form 1099-A Box 4 & and Form 1099-C Box 7. Fair Market Value (FMV) of Property***

Prior to 2014, the IRS instructions for box 7, FMV of Property, did not address short sales and stated:

"If you are filing a combined Form 1099-C and 1099-A for a foreclosure, execution, or similar sale, enter the FMV of the property. Generally, the gross foreclosure bid price is considered to be the FMV. If an abandonment or voluntary conveyance to the lender in lieu of foreclosure occurred, enter the appraised value of the property."

### **Audit Technique**

A lender generally will conduct an appraisal prior to the short sale of property and the FMV should be known. However, the IRS has noted that some Forms 1099-C have been issued with a zero FMV amount. Under these circumstances, the amount realized in a short sale is the sales amount.

## ***Form 1099-A & Form 1099-C Box 5. Check here if the Debtor was Personally Liable for Repayment of the Debt***

The IRS instructions for Forms 1099-A and 1099-C provide, “If the debtor was personally liable for repayment of the debt at the time the debt was created or, if modified, at the time of the last modification, enter an “X” in the checkbox”.

Box 5 does not specifically instruct the lender to identify whether the loan itself was recourse or nonrecourse, but rather whether the borrower is liable to repay the debt. If the lender has decided to forgive the outstanding debt, the borrower is technically no longer liable. As such, the instruction may be interpreted as the borrower is no longer liable for the outstanding debt through a short sale and, therefore, the box is not checked.

The loan documents will identify whether the debt was recourse or nonrecourse. Some states may identify the original loan as nonrecourse and if the loan is modified, it becomes recourse.

### **Audit Techniques**

- Obtain a copy of the loan documents to determine whether the loan was recourse or nonrecourse. Look for language such as power of sale that explains the actions that a lender may take if the borrower defaults on the loan.
- If the taxpayer no longer has the records, summons the lender for a copy of the loan documents.
- Seek assistance from local Counsel for specific state law questions.

## ***Form 1099-C Box 6. Identifiable Event Code***

Box 6 may be left blank by a lender. The instructions are very self-explanatory, “Enter the appropriate code to report the nature of the identifiable event...” However, a lender may conclude that a short sale does not qualify as an identifiable event. Short sale should be included as an identifiable event F, “A discharge of indebtedness under an agreement between the creditor and the debtor to cancel the debt at less than full consideration.”

### **Audit Technique**

During the initial interview, ask the taxpayer or representative the facts and circumstances regarding canceled debt. The type of disposition will help to identify any additional documents to request.

## Chapter 8 – Community and Common Law Property

### Community and Common Law Property Systems

Only an overview of community and common law property rules are presented due to the complex issues that could arise. For complete procedural guidance refer to IRM 25.18, Community Property, and Publication 555 for additional information on married taxpayers domiciled in common law and community property states.

Consideration of the ownership of foreclosed property may have different tax consequences for taxpayers who own separate property from their spouses. The state where the taxpayers live may have an impact on how a foreclosure is reported. Federal tax is assessed and collected based upon a taxpayer's interest in property and state law. Thus, the effect on each spouse should be addressed and case file documentation should include property considerations.

Whether property is characterized as community property becomes less important if a joint filing election is made. Spouses filing a federal joint return are jointly and severally liable for the tax on all income of both spouses reportable on the joint tax return, whether it is community property or separate property.

Forty-one states have adopted common law property systems. Common law treats each spouse as a separate individual with separate legal and property rights. Generally, each spouse owns and is taxed on the income that is separately earned.

Nine states have adopted the community property system. These states are Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington and Wisconsin. Alaska has also adopted a community property system, but it is optional. The U.S. Territory of Puerto Rico is also a community property jurisdiction. Community property is where each spouse contributes labor for the benefit of the family and shares equally in the profits and income earned by the family. Thus, each spouse owns an automatic fifty percent interest in all community property, regardless of which spouse acquired the community property.

### Community Property

Generally, community property is property that the taxpayer, taxpayer's spouse or both spouses together acquire during their marriage while the taxpayer and taxpayer's spouse are domiciled in a community property state, property agreed upon to convert from separate to community property, and property that cannot be identified as separate property. Refer to Publication 555, Table 1 for more information.

Spouses are also considered to share debts. Each community property state has its own specific property laws. Depending on state law, creditors of spouses may be able to obtain all or part of the community property, regardless of how it is titled, to satisfy debts incurred by either spouse. State laws vary greatly on what property can be reached.

In *Aquilino v. United States*, 363 U.S. 509 (1960) and *Morgan v. Commissioner*, 309 U.S. 78 (1940), the court decided that Federal law determines how property is taxed, but state law

determines whether, and to what extent, a taxpayer has "property" or "rights to property" subject to taxation. Accordingly, federal tax is assessed and collected based upon a taxpayer's state created rights and interest in property.

IRM 25.18.1.1.4, Tax Assessment and Collection under Community Property Laws, states that, for income tax purposes, if spouses file separate returns, each spouse is taxed on 50% of the total community property income regardless of which spouse acquired the income. *Poe v. Seaborn*, 282 U.S. 101 (1930). In addition, each spouse is taxed upon 100% of his or her separate property income. Community property may also affect basis in property.

Refer to IRM Exhibit 25.18.1-1, Comparison of State Law Differences in Community Property States, for a summary of the differences in the community property laws adopted in the nine community property states.

Generally, separate property is:

- Property that the taxpayer or taxpayer spouse owned separately before their marriage.
- Money earned while domiciled in a non-community property state.
- Property that the taxpayer or spouse received separately as a gift or inheritance during their marriage.
- Property that the taxpayer or spouse bought with separate funds, or acquired in exchange for separate property, during their marriage.
- Property that the taxpayer and spouse converted from community property to separate property through an agreement valid under state law.
- The part of property bought with separate funds, if part was bought with community funds and part with separate funds.

### ***Income***

Dividends, interest, and rents from community property are community income and must be evenly split. Income from separate property is separate income in Arizona, California, Nevada, New Mexico, and Washington. Idaho, Louisiana, Wisconsin, and Texas characterize income from separate property as community income.

### ***Deductions***

When married taxpayers file separate returns, deductions generally depend on whether the expenses involve community or separate property. Refer to Publication 555, section entitled *Community Property Laws are Disregarded* for more information.

### ***Gains and losses***

Gains and losses are classified as separate or community property depending on how the property is held. For example, a loss on property, such as rental property held separately, is a separate loss. On the other hand, a loss on property, such as a casualty loss on a home held as community property, is a community property loss. See Publication 544, Sales and Other Dispositions of Assets, for information on gains and losses.

**Example 35.** Henry and Mabel are married and filed separate tax returns. They live in a community property state that treats income from separate property as community income. Their income during the year is summarized in the following table as follows:

**Community Property Income**

<b>Income Description</b>	<b>Henry</b>	<b>Mabel</b>	<b>Total</b>
Wages	20,000	22,000	42,000
Consulting business	5,000		5,000
Partnership		10,000	10,000
Rent from community property	25,000	25,000	50,000
Dividends from separate property	1,000	2,000	3,000
Total community property income	\$51,000	\$59,000	\$110,000

Considering the facts in this example, Henry would report \$55,000 (110,000 divided by 2) and Mabel would report \$55,000 (\$110,000 divided by 2), on their separate tax returns. However, Henry would report self-employment tax on the entire \$5,000 from his consulting business. Note that there are exceptions in all states that treat some items of income as separate property. Refer to IRM 25.18 and Counsel for additional guidance.

**Example 36.** Fred and Robin are married and live in a home that they purchased together. Fred owns a second home that he purchased prior to marriage. They fell on hard times and Fred became delinquent on the mortgage of his second home. Because of nonpayment, the bank notified him that it would foreclose on the home. A month later, the lender approved his loan modification under one of the Making Home Affordable programs and canceled a portion of the mortgage loan (recourse debt). The taxpayers filed separately. SP means separate property in the following information.

First, determine whether Fred can exclude cancellation of debt income under the insolvency exclusion. Secondly, determine whether Fred can exclude cancellation of debt income under the qualified principal residence indebtedness exclusion. Fred’s canceled mortgage debt \$75,000.

Additional facts include Liabilities and Assets immediately before the discharge of debt:

- Jointly owned liabilities \$250,000
- FMV of jointly owned assets \$525,000
- Fred’s mortgage (SP) \$200,000
- FMV of Fred’s home & assets (SP) \$155,000

CP = Community Property; SP = Separate Property

### Insolvency Calculation

<b>Assets and Liabilities</b>	<b>Fred</b>	<b>Robin</b>	<b>Totals</b>
Liabilities (CP)	125,000	125,000	250,000
Fred's mortgage (SP)	200,000	0	200,000
Total Liabilities	325,000	125,000	450,000
Less:			
Assets (CP)	262,500	262,500	525,000
Fred's assets (SP)	155,000	0	155,000
Total Assets	417,500	262,500	680,000
<b>Insolvent</b>	<b>0</b>	<b>0</b>	
CODI	75,000		75,000

In summary, Fred was solvent by \$92,500 (\$325,000 total liabilities minus \$417,500 total assets). Robin was solvent by \$137,500 (\$125,000 total liabilities minus \$262,500 total assets).

Because Fred purchased the second home prior to marriage, his property is treated as separate property. Since Fred is solvent, he would report the entire \$75,000 of the canceled debt as other income on his tax return. Robin is not required to report any of the canceled debt in her income.

Fred cannot exclude the \$75,000 under the qualified principal residence indebtedness exclusion, as the cancelled debt was debt related to his second home and not his principal residence. Fred does not qualify for any other exclusion.

## Chapter 9 – Audit Strategies

### Summary of Real Estate Property Audit Strategies

When a taxpayer defaults on a loan or abandons their property, they may not have documents related to the sale of the property. Consequently, summoning third parties (or third party records) may be necessary. The following list summarizes the audit strategies discussed in this guide.

- During the initial interview, ask the taxpayer questions to establish the facts and circumstances that led to the disposition or loan modification. If CODI was excluded from income, establish whether the taxpayer qualified to exclude income under the exclusion.
- Pull property records upon receipt of a case to identify property owned and disposed of and all loans associated with the property.
- A reconciliation of the IRP to the return is a required Minimum Income Probe step (IRM 4.10.4.3.2 Nonbusiness returns and IRM 4.10.4.3.3 Business returns). During this reconciliation, review the IRP for issuance of a Form 1099-A and/or Form 1099-C. This will help to identify whether or not an income issue exists, because the taxpayer may not have reported a foreclosure or other type of disposition on the tax return.
- Request the taxpayer's calculation of CODI and gain/loss of a property. Ask about any large, unusual, or questionable items and ask for supporting documentation when warranted.
- All mortgages should be included in the calculation of gain/loss and CODI. (Note: lenders, erroneously, do not always issue Forms 1099-C on all mortgages, especially second mortgages, or where the second mortgage is from a different lender). Review property records and consider looking at prior years' IRP for Forms 1098. These documents will identify whether the debt was being paid and, possibly, whether the debt should be considered in the disposition calculation(s).
- Review the final HUD-1 for loan modifications and dispositions. There are a few federal, state, and lender incentives that the taxpayer may qualify for. Identify whether a loan modification incentive received is taxable. For dispositions (e.g., short sales), a taxpayer may receive funds to cover relocation expenses. This may be listed on the HUD-1 as "relocation assistance". This amount generally is taxable and should be included in the sales price on Schedule D or Form 4797.
- When loan or sales information is in question, request the final HUD-1 from the lender or search public property records for recorded loan information, foreclosure notices, grant deed and/or title transfer for the disposition. The taxpayer might not have a copy of these documents if the home was foreclosed or disposed through a deed in lieu of foreclosure. These documents will identify pertinent information such as, the sales amount, date of title transfer, identifiable event, etc.
- Note that the final HUD-1 may not list the total debt owed at disposition. The HUD-1 will show the sales price and the amount of the proceeds that will be applied towards the loan balance right before the sale. You will need to add the amount forgiven to the sales price to identify the approximate amount owed right before the disposition. Also, review property records, the last monthly loan statement, loan documents, and/or other documents to identify the loan balance owed right before the disposition.
- Request purchase and refinance documents to determine the adjusted basis. Ask the taxpayer how the funds were used if the property was refinanced. Any amount used for

personal purposes is not qualified indebtedness under the principal residence, farm, and real property business exclusions.

- Request a copy of the insolvency calculation. Ask about any questionable items and request supporting documentation when warranted. Refer the taxpayer to Publication 4681 to complete the insolvency worksheet if insolvency is claimed during the audit. The insolvency exclusion is not an election and can be utilized even during an examination.
- As part of the insolvency calculation, look for any liabilities that should have a corresponding asset. For example, if a car loan is listed, the fair market value of the vehicle should be listed under assets, unless the vehicle was repossessed.
- Generally, mortgage lenders will conduct an appraisal of the property during a short sale process. Therefore, a comparison of the fair market value on the Forms 1099-A and/or 1099-C with the taxpayer's insolvency calculation can be done to identify any differences. If you do identify any differences, request that the taxpayer explain how they determined the fair market value of the property particularly if the difference puts the taxpayer in an insolvent position.
- Sometimes taxpayers attempt to convert their principal residence into rental real estate property right before it forecloses. Then, the losses and non-deductible personal expenses (e.g., property insurance) are deducted as passive losses and deductions, respectively. Determine why the taxpayer converted the residence to a rental and whether it was formally the taxpayer's principal residence or second home and the resulting tax consequences. Evaluate whether the conversion was temporary or a permanent conversion to a valid rental activity.
- Non-issuance of a Form 1099-C does not relieve taxpayers of their responsibility to include CODI in income. Identify all loans on the property by reviewing IRP and property records. All loans should be considered in the CODI and gain/loss calculations.
- Consider state foreclosure laws for the state where the property is located. For example, at times taxpayers are not issued Form 1099. The state law will help to determine whether the lender forgave any debt.
- When CODI, Form 4797 gain/loss or Schedule D gain/loss, and Schedule E gain/loss for all years are netted and result in a loss, consider whether the taxpayer is "poorer" by that amount. If the taxpayer could not afford to sustain that loss then how did he/she fund the losses (e.g., other debt, current year income, or other assets)?

## **Case File Documentation**

Cases involving foreclosures should include the following information/documentation:

- Any document that helps to provide a financial picture of the taxpayer at the time of the foreclosure. For example, house and car loans, credit card bills, utility bills, earnings statements, bank statements, check registers, investment statements, etc.
- Any information evidencing that the debt was not in fact collected
- Any Forms 1099-C or Forms 1099-A
- Completed Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, and/or Form 433-B, Collection Information Statement for Businesses, along with supporting documentation (as warranted)
- Results of any interview with the taxpayer
- Documents collected from the taxpayer as a result of an interview
- Bankruptcy documents (such as the bankruptcy petition and plan) if the taxpayer filed a Chapter 7, 11, 12 or 13 bankruptcy at the time of the foreclosure.

## Standard Paragraphs and Explanation of Adjustments

See IRM 4.10.10, IRM Exhibit 4.10.10-1, and IRM Exhibit 4.10.10-2.

### Job Aids

#### ***Job Aid 1 – Insolvency Worksheet located in Publication 4681:***

[Publication 4681](#), (PDF), Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)

#### ***Job Aid 2 – Sample HUD-1: [Settlement Statement \(HUD-1\)](#) (PDF)***

#### ***Job Aid 3 – Sample Information Document Request:***

Only the applicable information as it relates to the taxpayer should be requested.

### General Questions

- Was the loan(s) that secured the property recourse or nonrecourse? Provide the documentation relied upon to make this determination.
- What information was relied upon to determine the gross sales price?
- How was the cost basis determined?
- If cancellation of debt was excluded from income, provide the last loan statement showing the balances for all loans that secured the property right before the foreclosure, deed in lieu of foreclosure or short sale.
- Provide documentation to support the exclusion of cancellation of debt income (e.g., insolvency, farm, or real property business computations).
- Provide bankruptcy discharge documents.
- Provide attribute reduction calculations, as applicable.
- What method of depreciation was used to depreciate the disposed property?
- Provide a copy of the final HUD-1 or other document(s) for the sale of the property.
- Did you receive any relocation assistance funds or other monies under a program? If yes, how much was received and how was it reported on the tax return?
- Was the loan(s) refinanced anytime during ownership of the property? If yes,
  - How much was received?
  - How were the funds used?
  - Provide a copy of the original purchase loan documentation.
  - Provide a copy of the refinanced loan documentation.
- If the property was refinanced and funds were totally or partially used for the property, provide documentation (e.g., invoices, receipts) that shows the amount and type of expense.

### Document Request for a Loan Modification

- Was any money received from the lender as a result of a loan modification? If yes, provide the amount received and how it was used.
- Was any money received under a Home Affordable Program? If yes, provide the amount and where this amount was reported on the tax return. If the amount was nontaxable,

provide the name of the Home Affordable Program or other program and information that explains the funds were nontaxable.

- Provide documentation to support the exclusion of cancellation of debt income (e.g., bankruptcy, insolvency, farm, or real property business computations).
- Provide documentation to support that the property was used as a principal residence (e.g., utility bills, driver's license, etc.). [Note to examiner: This issue is very factual driven meaning that requested documentation would depend on the facts and circumstances].
- Provide a copy of the HUD-1 for the loan modification.

#### ***Job Aid 4 – Sample Initial Interview Questions – Principal Residence:***

##### **Schedule D**

- What is your current address?
- How was the property disposed? (For example, abandonment, foreclosure, deed in lieu of foreclosure, or short sale).
- Provide a brief history of the events that led to the foreclosure.
- Where did you live before and after the foreclosure?
- What date did you move?
- What date was the property purchased?
- How was the sales amount reported on your return determined?
- Did the lender give you a monetary incentive to vacate the property? If yes, how much? Was this amount included in the sales amount reported on the return?
- How was the cost basis determined?
- Did you refinance during anytime of your ownership of the residence? If yes,
  - How much did you receive?
  - How were the funds used? (Need amount used for the residence and amount used for other purposes).
- Was the property used as rental property anytime during ownership? If yes, when? How much? Was the property rented for fair rental value? etc.
- Did the lender forgive you of the outstanding balance after the residence was sold?
  - If yes, did you receive a Form 1099-C? Was it accurate? What was inaccurate?
  - If no, did the lender receive a deficiency judgment? How much? How are you paying for the deficiency?
- If the cancellation of debt income was excluded from income under the qualified principal residence indebtedness exclusion, was the refinanced amount considered in the amount excluded from income? (Non-qualified portion may be taxable CODI).

#### **Resources for Real Estate Foreclosures and Cancellation of Debt Income**

[Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments](#) This publication explains the federal tax treatment of canceled debts, foreclosures, repossessions, and abandonments.

##### [Passive Activity Loss Audit Technique Guide](#)

This Audit Technique Guide provides examiners with specific guidance on potential audit issues, issue identification, lead sheets, and other job aids.

[The U.S. Department of Housing and Urban Development](#)

The Department of Housing and Urban Development administers programs that provide housing and community development assistance. The Department also works to ensure fair and equal housing opportunity for all.

[Partnership Audit Technique Guide Chapter 8 Real Estate Issues in Partnerships](#)

This Audit Technique Guide provides examiners with specific guidance on potential audit issues, issue identification, lead sheets and other job aids. Real estate issues in partnerships are covered in chapter 8.

[Farmers Audit Technique Guide Chapter Eleven Other Issues](#)

This Audit Technique Guide contains examination techniques, common and unique industry issues, business practices, industry terminology, and other information to assist examiners in performing examinations. Cancellation of indebtedness is covered in chapter 11.

## Chapter 10 - Rehabilitation Credit and IRC §469

### Background

IRC §47 allows a tax credit for the rehabilitation of a qualified building as defined in IRC §47(c). The rehabilitation credit applies to costs that are incurred for rehabilitation and reconstruction of certain buildings. In the case of a building other than a certified historic structure, a building is not a qualified rehabilitated building unless the building was first placed in service before 1936. Rehabilitation includes renovation, restoration, and reconstruction. It does not include enlargement or new construction. The certified historic credit is co-administered with the National Park Service and the State Historic Preservation Office.

The credit is an investment tax credit and is:

- 10% of the qualified rehabilitation expenditures with respect to any qualified rehabilitation building other than a certified historic structure and
- 20% with respect to the qualified rehabilitation of a certified historic structure.

The credit is temporarily increased for property located in specific disaster areas:

- For pre-1936 buildings (other than certified historic structures), the credit percentage is increased from 10% to 13%.
- For certified historic structures, the credit percentage is increased from 20% to 26%.

If the rehabilitation credit is generated by a rental activity, IRC §469(i) generally limits the deduction to the tax equivalent of \$25,000 (\$7,000 in the 28% bracket). Furthermore, while the active participation standard is not required for the rehabilitation credit, it is phased out beginning at modified AGI of \$200,000. Generally, no rehabilitation credit may be deducted if the taxpayer's modified AGI exceeds \$250,000.

A rehabilitation credit may be generated by a business in which the taxpayer materially participates (works on a regular, continuous, and substantial basis). If the credit is generated by a business (not a rental activity) in which the taxpayer works, it is not limited by the passive loss rules under section 469.

Under IRC §469(c)(7), beginning in 1994, a qualifying real estate professional may be able to deduct his entire rehabilitation credit if he/she materially participates in the rental activity generating the credit. The rehabilitation credit is reflected on Form 8582CR which is carried to Form 3468 which is carried to Form 3800 which is ultimately carried to Form 1040 under other credits.

If the credit is generated by a rental activity or by a business in which the taxpayer does not materially participate, losses are limited under section 469(i) to the tax equivalent of \$25,000.

It is important to note that a taxpayer cannot deduct a credit of \$25,000, but instead is allowed the tax equivalent of \$25,000 for the rehabilitation credit. Thus, for example, a taxpayer in the 28% bracket could deduct a credit of up to \$7,000.

There have been substantial examination issues where taxpayers failed to limit the rehabilitation credit to the tax equivalent of \$25,000 or failed to consider the modified AGI limitations. Rehabilitation credits disallowed must be carried forward. Credits suspended due to the passive loss provisions also must be carried forward and they cannot be carried back per IRC §469(b).

## Audit Hints

- Check Form 8582CR for any passive credits that exceed \$9,900 (the total passive credit allowable for a taxpayer in the 39.6% bracket). If there is no Form 8582CR, it is an indicator that the taxpayer ignored the passive limitations.
- If adjusted gross income exceeds \$250,000, no rehabilitation credit is deductible (unless the taxpayer has passive income which is relatively rare).
- Scrutinize carefully, any large amounts of passive income on Form 8582CR line 6 to verify that the character is truly passive.

For additional information and audit techniques on the rehabilitation credit and PAL refer to:

[RehabilitationCreditMSSPGuide](#) (PDF)

[RehabilitationTaxCreditRealEstateTaxTips](#)

[PassiveActivityLossAuditTechniqueGuide](#)

# Chapter 11 – Low Income Housing Credit

## Low-Income Housing Credit

IRC §42 provides a credit for investment in low-income housing. Virtually all IRC §42 properties are owned by partnerships and the low-income credit is a flow-through item. The IRC §42 credit is included in the General Business Credit under IRC §38(b)(5) and subject to the carryback and carryforward rules under IRC §39.

Form 8586, Low-Income Housing Credit, is filed with the taxpayer's tax return to claim the credit. The allowable credit (as reported on Schedule K-1) is reported on line 4 of Part I or line 11 of Part II, depending when the low-income buildings were placed in service. Form 8582CR is used to determine any passive activity limitation. IRC §469(i)(6)(B) provides an exception for IRC §42 credits; e.g., there is no active participation requirement for the \$25,000 offset and there is no phase-out of the credit based on modified Adjusted Gross Income. Therefore, a taxpayer may use the credit to offset taxable income subject to the \$25,000 limit.

## \$25,000 Offset

IRC §469(i) provides only one \$25,000 offset for losses and credits combined. The sum total of passive losses on Form 8582, line 10 and the credit equivalent on Form 8582CR cannot exceed \$25,000 unless the taxpayer has passive income.

Under IRC §469(i)(3)(E), the \$25,000 offset is absorbed first by passive losses, then by any passive activity credit, then by the rehabilitation credit, and finally by the low income housing credit. If the \$25,000 offset is completely used up by passive losses, no passive credit may be used. For example, if the taxpayer deducts \$25,000 in rental real estate losses under the provisions of IRC §469(i), no passive credit may be used, unless the taxpayer has passive income. Similarly, if the taxpayer deducts \$20,000 in rental real estate losses, only the tax deduction equivalent of \$5,000 (approximately \$1,750 credit for someone in the 35% bracket) remains for passive credits.

## Disposition of Passive Activity

On disposition of a passive activity to an unrelated party in a fully taxable transaction, excess current and suspended losses are fully deductible (after having been subjected to basis and at-risk limitations). However, IRC §42 credits are not automatically allowable in full. Instead, the taxpayer has two choices:

1. The taxpayer may elect to increase the basis of the IRC §42 project (or an interest therein) by completing Form 8582CR, Part VI, or
2. The taxpayer may continue to carry forward the credit and continue to claim the credit as the \$25,000 offset is available.

If auditing a partnership that lost an IRC §42 project to foreclosure (or transaction in lieu of foreclosure), no credit is allowable in the year of the disposition and the taxpayer may be subject to recapture of a portion of the credit claimed in prior years.

For additional information and audit techniques on low-income housing credit, refer to the [Guide for Completing Form 8823](#), Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition.