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Of Foreclosures, Short Sales, Taxes & Relief

from the desk of David M. Touchstone

In this time of declining real estate values, I am getting a significant increase in inquiries related to the income tax treatment of actions (or inactions) by debt strapped owners of real estate.

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When it comes to income tax, I am out of my water. Nevertheless, sometimes circumstances require us to muddle through, and, thus, even though the little pixie sitting on my shoulder as I write this keeps whispering in my ear Alexander Pope's famous admonition, "Fools rush in where angels fear to tread", I'm game to take the plunge if you want to swim along with me.

First, let's identify the types of unhappy real estate events that raise the specter of the tax man. They are three in number: foreclosure, dation en paiement, and short sell. A foreclosure transpires when a mortgage holder causes the property that is the object of the mortgage to be seized and sold at public auction. A dation en paiement occurs when a debtor deeds the property to the mortgage holder in partial or total satisfaction of the debt. The words "dation en paiement" are French and translate to "giving in payment"; in common law states, this type of transaction is usually referred to as a "deed in lieu of foreclosure" or "deed in lieu" for short. The third type of transaction, "short sell", describes a sale from the debtor to a third person in which the mortgage holder releases the mortgage from the property for *less than* pay off of the full amount due.

For purposes of this article, we will make a couple of assumptions. The first assumption that we are making is that in each of these three situations the creditor is getting paid or receiving value that is less than the full amount owed to the creditor. The second assumption that we are making is that the indebtedness owed to the mortgage holder is *recourse* debt, as opposed to non-recourse debt. Debt is said to be recourse when the debtor is personally liable as opposed to the situation in which the creditor can only recover the collateral in event of the debtor's default.

Before we tackle the tax treatments of the three types of disposition, I want to discuss with you an important tax term for those of you who are like me and are "challenged" when it comes to accounting and tax termi-

nology. The term we need to learn is "adjusted basis". First, let's start with "basis". Anytime a person becomes the owner of any item of property, at the moment of his acquisition, he has a "basis" in that item of property. If he acquires the property by purchasing it, his basis is the amount he pays for the property. If he holds the property over time and takes periodic annual tax deductions called "depreciation" (that theoretically correlate with wear and tear on the property over time), his "basis" is "adjusted" downward by the amount of the depreciation he has claimed. Accordingly, his basis as reduced by depreciation becomes his "adjusted basis". On the other hand, if he builds new structures or makes renovations of the property, his basis is increased by the cost of the new structures and renovations. In this latter instance, his "basis" will be "adjusted" by the amount of his cost and the increased amount of the basis becomes his "adjusted basis". An owner's basis is not the amount he borrows to buy the property; his basis is the price he pays to buy the property. This is an important distinction to keep in mind. Likewise, it is important to keep in mind *the purpose* for which the owner has incurred the mortgage indebtedness, a subject which we shall further explore when we get to the end of this article.

If a creditor holds recourse indebtedness, and forecloses on his real estate mortgage, a taxable event occurs for the debtor on the day that the property goes to public auction that may result in the debtor owing substantial income tax *even though the debtor received no money as a result of the foreclosure*. If, for example, the debtor owes the creditor $250,000 and the debtor's adjusted basis in the property is $180,000 and the high bid at the sheriff sale is $200,000, tax law considers that the debtor receives a $20,000 capital gain and $50,000 of ordinary taxable income, if the creditor does not pursue the debtor for the difference. In other words, if the creditor who acquires ownership of the property at the sheriff sale decides not to press his claim against the debtor any more, the debtor is considered to be getting off a $50,000 hook. In tax law, this is called "discharge of indebtedness" and has the equivalent effect of the debtor receiving $50,000 in ordinary income. In the example given above, let's consider the different outcomes depending on whether the property is investment property as opposed to being the debtor's home. If the property is investment property, the debtor will have to pay tax on the $20,000 gain (which may or may not be taxed at a long term capital gain rate depending on the amount of time the debtor has owned the property and what type of depreciation he has used), and will have to pay tax on the $50,000 ordinary income represented by the $50,000 discharge of indebtedness. On the other hand, if the property is the debtor's home (and he has lived in it for any two of the five years preceding the sheriff sale), the tax treatment will be as follows: (a) the debtor will not have to pay any income tax on the $20,000 capital gain because he has a homeowner deduction available to him up to the amount of $250,000 (or $500,000 for married couples) that will zero out the capital gain; and (b) the debtor will have to pay income tax on the $50,000 discharge of indebtedness as ordinary income.

The numbers will work the same if, instead of the property going to foreclosure, the debtor makes a dation en paiement (deed in lieu) to the mortgage holder. One point of difference here is that there will be no bid price, unlike the case of a foreclosure sale, to set the "sale" amount. In this instance, the Internal Revenue Service will look to the fair

market value (or what a willing buyer will pay a willing seller). A moment of reflection here is worth our time. My experience has been that in every sheriff sale I have ever attended (and that's a big bunch of them), the high bid has always been substantially less than the true market value of the property. The Internal Revenue Service's regulations take the position that the bid price at a sheriff sale, absent clear and convincing proof to the contrary, *is* the fair market value of the property. If you are assisting a debtor who has the option of giving the property to the creditor as opposed to the property going through a sheriff sale, this is a no brainer; the debtor should give the property back. By giving the property back, he can squeeze down the amount of the discharge of indebtedness and thereby reduce the bill to the tax man.

The example of the tax treatment set forth above in the foreclosure context holds true in a short sell arrangement. But here again, you should advise the client to work out a short sell (if this option is available to him). A short sell will have the effect of establishing a clear sale price at the highest number available and, therefore, the debtor will have both the certainty of a sale price (as opposed to the nebulousness of "fair market value") and will be squeezing down the discharge of indebtedness number to the smallest amount possible.

If you are one of those "duck on the June Bug" quick real estate agents, as I know you are, at this point you might be asking yourself "How's the government even going to know that my client has received a discharge of indebtedness?" Here's the answer: in most instances institutional lenders such as banks and mortgage companies are required to report to the IRS a discharge of indebtedness at which time they are required to issue a 1099-A or a 1099-C. In other words, the lender will be ratting out the poor debtor to the IRS. If the debtor's number on his tax return doesn't match the 1099-A or the 1099-C, the debtor better be prepared to explain the difference. In addition to being required by law to make these reports, lenders have their own economic motivation; in most discharge of indebtedness situations, the lender will be absorbing a business loss and will wish to report the loss on its own tax return to offset gains.

Well, you know how we lawyers can be. Now that I have explained to you the general rules, and just when you are starting to understand all this, I have to spoil everything by talking to you about the exceptions.

Among certain other exceptions, income tax law will permit a debtor to avoid taxation on the discharge of indebtedness gain if (a) he files bankruptcy or (b) he is insolvent at the time of the discharge of indebtedness. By insolvency, I mean that the total amount of all the debtor's debts exceeds the total value of all the debtor's assets.

Here's the other big exception: The Mortgage Forgiveness Debt Relief Act of 2007 (hereafter referred to by me as the "Debt Relief Act"). This law was enacted in December, 2007 as a result of President Bush's desire to provide some relief to homeowners distressed by the credit crisis. This law is only temporary in nature. Specifically, it can be applied to a discharge of qualified mortgage indebtedness occurring from January 1, 2007 through December 31, 2009, but only if the mortgage indebtedness pertains to the debtor's principal residence, and only if the discharge of indebtedness is directly related to a decline in the value of the residence. Did you notice that I used the words

"qualified mortgage indebtedness"? Here's the deal: if the debt that is being discharged by foreclosure, dation en paiement, or short sell is purchase money debt, and does not exceed $2,000,000 for spouses filing jointly or $1,000,000 for single filers, then it is qualified mortgage indebtedness. Likewise, if the debt being discharged was used to renovate or otherwise improve the property, it too is qualified mortgage indebtedness under the Debt Relief Act. Let's entertain an example: The debtor purchases his home for $300,000, pays the loan down to $280,000, refinances the acquisition mortgage in the amount of $300,000, and spends the extra $20,000 on a new car. The debtor who has lived in his home for less than two years loses his job and has to sell the house in a short sell in which the mortgage holder agrees to discount the $300,000 balance to $250,000. Thus, the debtor receives the benefit of a $50,000 discharge of indebtedness. Without the benefit of the Debt Relief Act, the debtor will have to treat the entire $50,000 forgiveness of indebtedness as taxable income. If these facts occur between January 1, 2007 and December 31, 2009, the debtor, through the benefit of the Debt Relief Act, will have to treat only $20,000 of the $50,000 as taxable income. Let's look at another example: The debtor purchases his home for $300,000 with a 100% loan and six months later obtains a HELOC (home equity loan) for $100,000. The debtor uses $40,000 of the HELOC money to add a room onto the house and spends the other $60,000 on fun stuff (boat, car, vacation, etc.). Six months later, the debtor loses his job and is forced to sell his house on a short sell with the first mortgage holder getting $280,000 on its $300,000 balance and the second mortgage holder releasing its $100,000 loan for nada. Under the Debt Relief Act, the debtor will be relieved from paying any tax on the $20,000 discharge of indebtedness with the first mortgage holder. However, as to the HELOC second mortgage, the debtor will receive only a 40% break (the percentage of the loan proceeds he used to add value to the home); thus, as to the HELOC, the debtor will pay no tax on $40,000 of the discharged indebtedness, but will have to pay tax on the other $60,000 of discharged indebtedness.

Well, I figure by now your eyeballs are probably spinning around faster than Linda Blair's head in The Exorcist, so let me sum up by saying: "you, the agent, to keep your distressed homeowner clients out of tax trouble, should strongly encourage these clients to do a short sale (instead of letting the property go to foreclosure or making a dation en paiement)". Furthermore, your clients need to get busy and make that short sell soon while the mortgage companies are motivated and while your clients can still take advantage of the Mortgage Forgiveness Debt Relief Act. Right now is the time for the best tax deal a distressed homeowner is probably ever going to get.

I am indebted to Alice V. Frazier and to Gerald W. Hedgcock, Jr., who are partners at the Shreveport certified public accounting firm of Heard, McElroy, and Vestal. Alice and Gerry read over this article, got me out of the weeds in a couple of spots, and made helpful comments which are much appreciated. Nevertheless, any errors (or lack of details) are my oversights and not theirs. If you have clients who are in need of top flight accountants, you should consider referring them to either Alice at Afrazier@hmvcpa.com or Gerry at Ghedg@hmvcpa.com or telephone Alice or Gerry at 429-1525.