Real Property: Cancellation of Debt and Foreclosure

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The information contained in this presentation is current as of the date it was presented. It should not be considered official guidance.
Cancellation of Debt

- Economic benefit
- Gross income includes income from cancellation of debt (COD)
Exceptions

- Gifts
- Deductible debt
- Price reduced after purchase
Recourse Debt

- Debtor personally responsible to repay the loan
- COD income =
  - Debt Balance
  - Less: Fair Market Value
Nonrecourse Debt

- Debtor NOT personally responsible to repay loan
  - Loan secured only by the property
- Generally no COD income
Form 1099-C

• Issued by lender
• $600 or more of COD
• Debt discharged in Box 2
Exclusions under IRC 108

- Bankruptcy
- Insolvency
- Qualified Principal Residence Indebtedness
Bankruptcy Exclusion

• Title 11 Case
  – Includes Chapters 7, 11, 13
• Discharge granted by the court
• Discharge under a plan approved by the court
Insolvency Exclusion

- Exclusion applies to the extent of insolvency
- Insolvency calculation:
  Total liabilities before the discharge
  Less: FMV of total assets before the discharge
  = Extent of insolvency
Insolvency Example

Debt Balance $220,000
Less: FMV of Personal Residence (200,000)
Equals: Ordinary COD Income 20,000

Total Liabilities $240,000
Less: FMV of Assets (235,000)
Equals: Extent of Insolvency 5,000
Qualified Principal Residence Indebtedness Exclusion

- Mortgage Debt Relief Act of 2007
- Exclusion related to restructuring and cancellation of qualified principal residence debt
- Tax Years 2007 through 2012
Qualifications

• Principal residence
• Debt must be secured by that residence
• Debt used to acquire, construct or substantially improve
Limitations

• Qualifying debt up to $2 Million
• Qualifying debt up to $1 Million for MFS
• Discharge related to:
  – Decline in value of the home, or
  – Decline in homeowner’s financial position
No Exclusion For

- Second home
- Rental or investment property
- Business property
- Debt NOT used to acquire, construct or substantially improve the residence
- Closing costs rolled into the debt when refinanced
Only Part of Loan Qualifies

Canceled debt
Less: Non qualified debt
= Amount of Exclusion
Qualified Principal Residence Exclusion Example

Debt Balance $ 850,000
Less: FMV (735,000)
Canceled Debt 115,000
Less: Non-Qualified Debt (110,000)
Exclusion 5,000
Ownership of Home Retained

- Ownership of home retained after cancellation of qualified debt
- Reduce basis of residence by amount excluded – but not below zero
- Enter reduction on Line 10b of Form 982
Other Exclusions under IRC 108

- Qualified farm indebtedness
- Qualified real property business indebtedness
Reduction of Tax Attributes

1. Net operating losses
2. General business credits
3. Minimum tax credit
4. Capital loss
Reduction of Tax Attributes

5. Basis in property
6. Passive activity loss and credits
7. Foreign tax credit
Form 982

- Report COD exclusion
- Report amount excluded
- Reduction of Tax Attributes
Foreclosure Consequences

• Gain or loss from the disposition of the property
• Cancellation of debt income (if recourse debt)
Foreclosure Consequences
Nonrecourse Debt

- No COD Income
- Gain or loss =
  Debt Balance
  Less: Adjusted Basis
Foreclosure Example
Nonrecourse Debt

Debt balance $180,000
Less: Adjusted basis (175,000)
Equals: Gain from foreclosure 5,000
Foreclosure Consequences Recourse Debt

COD Income = Debt balance
Less: Fair Market Value

Gain or loss = FMV (limited to debt balance)
Less: Adjusted basis
Foreclosure Example
Recourse Debt

Debt balance $180,000
Less: FMV of personal residence (170,000)
Equals: Ordinary COD income 10,000
FMV of personal residence $170,000
Less: Adjusted basis (200,000)
Equals: Nondeductible loss (30,000)
on foreclosure
Form 1099-A

- Foreclosure or repossession
- Debt balance outstanding in Box 2
- FMV of property in Box 4
Personal Residence

- COD income may be excludible
  - Bankruptcy
  - Insolvency
  - Qualified principal residence
- Gain from foreclosure may be excludible
  - Principal residence
- Loss from foreclosure not deductible
Rental Property

- COD income may be excludible
  - Bankruptcy
  - Insolvency
- Reduction of tax attributes
- Gain or loss from foreclosure reported on Form 4797
Investment Property

- COD income may be excludible
  - Bankruptcy
  - Insolvency
- Reduction of tax attributes
- Gain or loss from foreclosure reported on Form 8949 - Schedule D
Real Estate Tax Center

- Tax Tips
- Avoiding Problems
- Trends and Statistics
- Related Links
- Tips on Rental Real Estate Income, Deductions and Recordkeeping
Additional Resources

- Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments
- Publication 544, Sales and Other Dispositions of Assets
- Publication 523, Selling Your Home
Summary

• Cancellation of debt creates income
• IRC 108 may allow for the exclusion of COD income
• Tax attributes must be reduced when COD income is excluded
Summary (cont.)

• Foreclosure results in a gain or loss as if the property was sold
• Exclusions do not apply to gain from foreclosure
Summary (cont.)

• Recourse debt:
  – Cancellation of debt income
  – Gain or loss from foreclosure

• Nonrecourse debt:
  – Gain or loss from foreclosure
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