NEW PROBLEM-SOLVING E-PUBLICATION:

How Property Owners in Foreclosure\Short-Sale Can Avoid Paying Taxes On 1099\Forgiveness of Debt

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Includes Avoidance Strategies for Both Homeowners in Foreclosure and Investment Property Owners in Foreclosure, With Full Tax Law Support

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How Property Owners in Foreclosure\Short-Sale Can Avoid Paying Taxes On 1099\Forgiveness of Debt

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The referenced sections are from ***The Renaissance Goldmine of Goldmine of Brilliant Tax Strategies Real Estate Investor's*****, A Tax Reduction Software System by Albert Aiello & Bill Noll. For more info go to https://TractionREIA.com/al**

NOTE: Internal Revenue Code will sometimes be abbreviated "IRC"; IRS regulations abbreviated "Reg".

How Property Owners in Foreclosure Short-Sale Can Avoid Paying Taxes On 1099\Forgiveness of Debt

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UPDATE: Tax Break for Certain Foreclosed Homeowners Who Incur Phantom Income When Their Mortgage Debt Forgiven

__As much as $2 million can be excluded for discharges

__But the forgiven debt must be on your *principal* residence, NOT on your second home or investment property.

__And the discharged mortgage must have been used to purchase, construct or improve your *principal* home, again NOT second homes or investment properties.

__Home equity loans and cash-out refinancing do NOT qualify, except for the portion used to make primary home improvements.

__And there is another hitch – the homeowner must file a form with the IRS (982) and the tax basis of the residence must be reduced by the amount of debt forgiveness excluded (which may later cause a taxable event to the homeowner).

The bottom line is this – while this law is a plus, it does not cover all cancelled debt on a principal residence; it does not cover second homes or investment properties; and it has some have hitches to it as per the above.

This special report will fill in these gaps and enable more property owners to avoid paying taxes on more types of forgiveness of debt.

Foreclosures Continue - With property buyers overpaying and overleveraging, foreclosures are on the rise across the country creating money-making opportunities for savvy real estate investors.

Short Sales - Along with this is an equity-creation technique known as a "short sale", where through special strategies, the lender gives the investor a discount on the mortgage balance thereby reducing the debt owed and thus increasing the property's equity from the get-go.

But this has also created a tax dilemma as per these questions I'm getting all of the time from my students:

- ***I had a lady who I bought her house through a short sale. Well the lady just received a 1099 from the bank for the balance of the mortgage owed because, as part of the short sale transaction, the bank released her from the mortgage owed which is income from debt forgiveness. I am finding this to happen often and homeowners going through foreclosure are consequently becoming reluctant or hesitant about doing the deal because they fear the tax consequences. Are banks right in doing this? If so, what can the homeowner do to avoid paying taxes in this situation?***

- ***I had a question pertaining to 1099C. If a person goes through a short sale\foreclosure, how are they able to avoid the tax burden?***

- ***Al, great to meet you at the boot camp in Dallas, TX. I am finalizing a short sale and have received a Demand Letter from the lender agreeing with my negotiated price of $70,700, which is substantially lower than the principal balance of $94,000. However, the lender has indicated they will probably send a 1099C to the borrowers (homeowners) and to the IRS. I believe the IRS considers this to be relief of debt in a short sale and is phantom income to the homeowner. How can this be avoided?***

- Another question I get… ***What can the property owner do to avoid paying taxes if the foreclosure property is not their home?***

OK, if a debt is canceled or forgiven, other than as a gift or bequest, the debtor *may* have to include the canceled amount in gross income for tax purposes. A debt includes any indebtedness for which the debtor is liable, or which attaches to property the debtor holds.

BUT JUST BECAUSE THE PROPERTY OWNER GETS A 1099 DOES NOT MEAN THEY OWE TAXES! MY STUDENTS ARE GETTING WRONG COSTLY ANSWERS FROM INEPT TAX ADVISORS. BUT FEAR NOT, WE HAVE THE SOLUTIONS!

A Foreclosure-Repossession of Property Is Like A Sale of a Property and Therefore Any Gain Is Eligible to Be Excluded or Deferred Through Certain Provisions in The Tax Law Such as The Section 121 Exclusions for Homeowners or the 1031 Exchange for Investment Property Owners

A SALE - First off, when you have a foreclosure-repossession of property you have what is called in tax law a "disposition" which essentially is the same tax treatment of a traditional sale of the property. That is, the tax law says that a gain (or loss) is recognized on the sale or *disposition* of a property, IRC 1001 (emphasis added on *disposition*).

A traditional sale of property is not the only type of "disposition" and is therefore not the only way to incur a gain. Another type of disposition that could result in a gain (or loss) is the foreclosure-repossession of a property where there is forgiveness or cancellation of debt. Internal Revenue Code Section 61(a)(12).

Foreclosures Involving Cancellation of Debt Have Their Own Special Rules of Gain or Loss Computation Along with Special Exclusions from Debt Cancellation Income for Homeowners and Investors

Before going any further, here are two real estate finance terms you should know:

1. Recourse Mortgage – This is where the debtor is personally liable on the debt either to a bank or the seller. The lender has "recourse" to pursue the debtor personally to attempt to attach their personal assets to satisfy the debt. (Most mortgages are recourse.)

2. Non-Recourse Mortgage – A non-recourse mortgage is where the debtor is not personally liable on the debt either to a bank or the seller. In the event of default, the lender takes only the property, not the other assets of the buyer.
A non-recourse mortgage is also referred to as a "subject to" mortgage or "exculpatory" mortgage.

<u>NOTE</u>: The terms *mortgage, deed of trust, loan, note* or *bond* is often used interchangeably to indicate the debt on the property even though *mortgage* or *deed of trust* is technically not the debt but the security for the debt.

GAIN AND LOSS EXAMPLES - Now let's discuss rules and examples of gain (or loss) computation in foreclosure repossession along with cancellation of debt. According to IRS Publication 523, the selling price (or *amount realized*) is generally the amount of canceled debt or sometimes the property's fair market value as per the following two rules:

(a) If the property owner is personally liable on the recourse debt (the usual case), the selling price includes the full amount of the debt but up to the property's fair market value. In other words, with recourse debt the amount realized is the *lower* of the canceled debt or the property's fair market value (FMV). Here you can have a deductible loss on a rental property.

<u>EXAMPLE 1</u>: With an adjusted basis of $142,000, a FMV of $57,336 and you are personally liable on the debt you have a fully deductible ordinary loss of $84, 664 which you claim on IRS form 4797 (part 1) attached to your 1040 for the year of the foreclosure disposition. This loss could also qualify as a net operating loss

(NOL) for refunds of past paid taxes, like one of my students who got a $10,000 refund.

OR…

(b) If the property owner is not personally liable on the non-recourse debt (not the usual case), the selling price includes the full amount of the debt cancelled by the foreclosure-repossession, regardless of the property's fair market value. With non-recourse debt, market value does not matter.

If the above amount realized in either (a) or (b) above exceeds the tax basis of the property (often the case), then there is a net realized gain, which could be excluded from taxes as per the strategies of this publication. However, unlike most normal sales, where there is cash to be received, a foreclosure disposition results in "phantom income" (the canceled debt), which is *non*-cash income, but subject to tax (unless again you employ the tax-reduction strategies of this publication).

Examples illustrating these rules of gain computation are the following:

<u>EXAMPLE 1A</u>: A property owner is foreclosed on and their property has an existing recourse mortgage of $100,000 on which the owner was personally liable. The fair market value of the property is $110,000. The lender releases the property owner of this mortgage and cancels the debt. The property has an adjusted basis of $60,000. The realized gain on this disposition is $40,000, which are the difference between $100,000, the debt canceled and the adjusted basis of $60,000.
Here the amount realized is the debt canceled which is less than the market value of $110,000 as per rule (a) above which states that, with recourse debt, the amount realized is the *lower* of the canceled debt or the property's fair market value.

<u>EXAMPLE 2</u>: Same facts as above, except that the fair market value of the property is $90,000 with again a recourse mortgage of $100,000, then the gain on this disposition is $30,000 ($90,000 value less the adjusted basis of $60,000). This time the amount realized is the property's market value of $90,000, which is *less* than the debt canceled of $100,000. So, we use the *lower* market value as the selling price, as per rule (a) above.

TIP: There is some room here for planning with a lower market value. Here, where the recourse debt exceeds the property value, at least part of the gain will be ordinary income. This will be discussed shortly.

EXAMPLE 3: A property owner is foreclosed on and their property has an existing *non*-recourse mortgage of $110,000 on which the owner was not personally liable. The fair market value of the property is $80,000. The lender releases the property owner of this mortgage and cancels the debt. The property has an adjusted basis of $60,000. The realized gain on this disposition is $50,000 which is the difference between the total debt canceled of $110,000 and the adjusted basis of $60,000. *Reason*: As per rule (b) above where the property owner is not personally liable (a non-recourse mortgage), then the amount realized (or selling price) is the total debt canceled regardless of the property's fair market value, even if the market value is less than the debt as in this example. However, if in this example, the owner was personally liable, then the realized gain would be $20,000 ($80,000 value less the adjusted basis of $60,000). Here the amount realized is the property's market value of $80,000 which is less than the debt canceled of $110,000 as illustrated in example 2 above. Remember, as per rule (a) above, with recourse debt the amount realized is the *lower* of the canceled debt or the property's fair market value.

TAX POINTERS TO THE ABOVE:

TAX POINTER 1. If the debt had to be included in income, it's not the amount indicated on the 1099C (*Cancellation of Debt*). This is a big costly misconception. It would be a lesser amount, namely the 1099 amount *less* the property's adjusted basis which equals the net gain as illustrated above. If the property's adjusted basis exceeds the amount realized (the canceled debt), then there is a loss, which may or may not be deductible depending on the tax classification of the property (personal or investment) as discussed in tax pointer 2, next.

TAX POINTER 2. If the debt had to be included in income, the character of the gain or loss (capital or ordinary) will generally depend on the tax classification of the underling property as follows:

(1) Personal-use property (primary residence or second home) - The gain is capital regardless of how long the home is held. If the home is held for one year and one day or more, the gain is long-term capital gain, which is taxed at lower rates. But if there is a loss (where the adjusted basis exceeds the amount realized), the loss is not deductible on such personal-use property.

(2) Investment\Rental (non-dealer) Property – If the property is held for one year and one day or more, the gain is long-term capital gain (outside of excess depreciation recapture). If one year or less, the gain is ordinary. Losses are deductible and are ordinary, regardless of the time held.

(3) Dealer property – Both gains and losses are ordinary, regardless of the time held.

Ordinary Income Exception: If the property owner is personally liable on the canceled debt (a recourse loan) and if the canceled debt is more than the property's fair market value, there is ordinary income equal to the difference between the higher amounts of canceled debt over the lower amount of the property's fair market value. This is so regardless of the property's tax classification. It is possible that the amount of debt could be more than the market value of the property, especially in short sale situations.

For example, referring back to Example 2, assume a residence and the homeowner was personally liable. The canceled recourse debt is $100,000, property's value is $90,000, adjusted basis is $60,000. Of the total gain of $30,000 ($90,000 value less adjusted basis of $60,000), $10,000 is ordinary income (which is the difference between the higher amount of canceled debt of $100,000 over the lower amount of the property value of $90,000). The remaining $20,000 of the total $30,000 gain is capital because this is category (1) above, a personal-use residence, which is a capital asset. But see the planning note, next.

PLANNING NOTE: For most property owners, there will be ways to totally exclude *all* income (capital or ordinary) from debt cancellation as discussed in this publication.

TAX POINTER 3. Just because the lender forecloses does not always mean that they forgive the debt when the borrower is personally liable with a recourse debt. When the sales proceeds of the property in a foreclosure sale are not enough to pay the loan balance there is a potential *deficiency judgment* against the borrower. Here the lender may not release the borrower from the loan liability and if this is the case, there is no taxable income (or loss) because there is no debt forgiveness and thus no amount realized and no taxable disposition. But with foreclosures, along with short sales, this is typically not the case as the property owner is totally released on the debt and thus there is a taxable disposition as per the above examples. But again, for most property owners, there will be ways to totally exclude income from debt cancellation as discussed in this publication with the following strategies.

TAX REDUCTION STRATEGIES FOR HOMEOWNERS

STRATEGY 1: USE THE SECTION 121 EXCLUSION OF GAIN – But does the Section 121 exclusion pertain to foreclosure repossessions?

ALERT: **This is an important question because many tax advisors and IRS agents will say "no" and thus cause the property owner to**

unnecessarily pay taxes. Therefore, at least some property owners will not sell their property to you because of the fear of the tax consequences on the debt cancellation by the lender. For you this means lost profits from foreclosure bargains.

But GREAT NEWS! The correct answer is yes, here is why. IRS Publication 523 (Selling Your Home) states this, *"If your home was foreclosed on or repossessed, you have a sale. You may qualify to exclude from your income all or part of any gain from the sale of your main home. If you qualify, you will not have to pay tax on the gain up to the limit under maximum exclusion"*.

Let's go further. Internal Revenue Code Section 121(a), (Exclusion Of Gain From Sale Of Principal Residence) states this, "*Gross income shall not include gain from the sale or exchange of property, if during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more"*. Therefore, these exclusions do pertain to foreclosure repossessions because IRS publication 523 states that a foreclosure repossession is a "sale" or "exchange" (exchange too is a disposition) eligible for these exclusions.

Also, IRC 121(a) states such a "sale" is entitled to the exclusion of gain, if the seller owned and used the property as their principal residence for at least 2 years out of 5 years before the sale.

If the seller is single the exclusion amount of gain is up to $250,000; if married filing jointly, the exclusion amount of gain is up to $500,000. Either way they would exclude the entire gain in the above examples. IRC 121(b).

Exceptions If Home Is Owned and Used for Less Than 2 Years, Then the Seller May Be Entitled to A Reduced Amount of The Exclusion

This is based on the following 3 exceptions to the 2-year holding requirement.

1. Health reasons, IRC 121(c)(2), Regulation 1.121-3T(d). Or
2. Change in place of employment, IRC 121(c)(2), Reg. 1.121-3T (c), Or
3. Other unforeseen circumstances, IRC 121(c)(2), Regulation 1.121-3T(e).

Note that these exceptions may be attributable to "qualified individuals" other than the taxpayer, which includes the taxpayer's spouse, a co-owner of the residence, or any person whose principal place of abode was the taxpayer's residence. These safe-harbor exceptions are further discussed:

1. Health Exception - Here, the definition is *broadened and liberalized* to include family members of qualified individuals, such as a sick child, parent, grandparent, or brother or sister. A sale that is made primarily to facilitate treatment or mitigate a qualifying individual's disease, illness, or injury qualifies for the reduced maximum exclusion. If a doctor* recommends a change of residence for health reasons, the sale automatically qualifies. The exception does not apply if the move merely improves general* health.

***TIP**: The doctor's report should be as *detailed* as possible and for a *specific* health problem and not just for improving general health. Remember, it's all in the documentation!

2. Change in Place of Employment Exception - A sale will qualify for a reduced exclusion under the change in place of employment exception if the new place of employment of a qualified individual is at least 50 miles* farther from the sold home than the old place of employment was. The change in employment must occur while the taxpayer owns and uses the home as a principal residence. Even if this safe harbor exception cannot be met, the exception still applies if the facts indicate that a change in place of employment was the primary reason for the sale, as a result of unforeseen circumstances, discussed next.

3. Unforeseen Circumstances' Exceptions - A sale qualifies for the unforeseen circumstance's exceptions if any of the following safe harbor events occurs during the taxpayer's ownership and use of the property:

(1) Involuntary conversion of the residence
(2) Damage to the residence from a natural or man-made disaster, war, or act of terrorism

Any of the following events affecting a qualified individual:

(3) Death
(4) Divorce (or legal separation)
(5) Becoming eligible for unemployment compensation
(6) Change in employment status* that leaves the taxpayer unable to pay housing costs and basic household living expenses (*Apparently the 50-mile test does not have to be met if the change in employment is a result of this unforeseen circumstance)
(7) Multiple births resulting from the same pregnancy
(8) Terrorist attacks such as 911

The IRS may expand the list of "unforeseen circumstances" in future announcements, or in rulings requested by individual taxpayers.

TAX PLANNING: Homeowners who owned and used their home for less than two years and have a taxable disposition through foreclosure, very well may be able to come under one of these exceptions to get at least a reduced amount of gain exclusion. For example, the disposition may be linked to exception 1 (health reasons*) or exception 2 (job change). *And remember, the health exception is broadened to include family members of qualified individuals, such as a sick child, parent, grandparent, or brother or sister. For the homeowner in foreclosure, probably the most common exception will come under exception 3 (unforeseen circumstances) reviewed as follows:

(1) Involuntary conversion of the residence – Typically the term "involuntary conversion", under IRC 1033, is from property destruction (such as fire, flood, etc.), or from government condemnation for public use. However, pertaining to these Section 121 exceptions, neither the code nor regulations give a definition of "involuntary conversion". Aside from any definitions to the contrary, a foreclosure-repossession certainly can be argued to be an involuntary conversion under this exception.

(2) Damage to the residence from a natural or man-made disaster, war, or act of terrorism – This may be possible, but not probable.

(**3) Death** – This is possible, but hopefully not. Certainly, don't rush it!

(4) Divorce (or legal separation) – This is very possible in the U.S. and with foreclosures. In fact, divorce and foreclosure often go together.

(5) Becoming eligible for unemployment compensation – This is more possible with a foreclosure where the homeowner loses their job.

(6) Change in employment status that leaves the taxpayer unable to pay housing costs and basic household living expenses – This is very possible and often probable. Many times, this is the *very cause* of the foreclosure – the homeowner cannot make the mortgage payments because of a change in employment status for one or both spouses, or just the one single homeowner.

(7) Multiple births resulting from the same pregnancy – This is possible, but not probable.

(8) Hopefully no terrorist attacks.

Also, the IRS may expand the list of "unforeseen circumstances" in future announcements, or in rulings requested by individual taxpayers. Hopefully foreclosure-repossessions may be specifically added to the list as such.

<u>TAX BREAK REMINDER</u>: These exceptions may be attributable to individuals other than the taxpayer ("qualified individuals") which includes the taxpayer's spouse, a co-owner of the residence, or any person whose principal place of abode was the taxpayer's residence.

IRS FILING: There is no specific tax reporting form for the Section 121 exclusions, although gains in excess of the exclusion amounts must be reported on Schedule D and if part of the home is used for business, IRS Form 4797. If the gains are under the exclusion amounts, usually no 1099 is issued. But with a foreclosure-repossession, the bank will generally issue the 1099C. If the Section 121 exclusions are used for the foreclosure disposition, the homeowner should attach a copy of the 1099C to their tax return and insert on the copy, *"The income from this disposition reported on this 1099 has been excluded under Internal Revenue Code Section 121(a); Regulation 1.121.1-1(a); IRS Pub. 523."*

<u>STRATEGY 2 FOR HOMEOWNERS</u>: COME UNDER EXCLUSIONS OF INCOME FROM DEBT CANCELLATION

Most likely, a primary homeowner should be able to meet the requirements for the above Section 121 exclusions. This could be even if the home is owned and used less than 2 years by coming under one of the previously discussed exceptions. But in the event, they cannot, or if the gain exceeds the Section 121 exclusion, there are also the Internal Revenue Code Section 108 exclusions from debt cancellation income, also referred to as the "COD" (cancellation of debt) rules. You do not include a canceled debt in gross income if any of the following situations apply:

1. BANKRUPTCY (Bankruptcy Case Exclusion) - The cancellation takes place in a bankruptcy case under the U.S. Bankruptcy Code, title 11. IRC 108(a)(1)(A). A bankruptcy case is a case under title 11 of the United States Code, but only if the debtor is under the jurisdiction of the court and the cancellation of the debt is granted by the court or occurs as a result of a plan approved by the Court. None of the debt that is canceled in a bankruptcy case is included in your gross income in the year canceled. IRS Publication 908. Instead certain losses, credits, and basis of property must be reduced by the amount of excluded income (but not below zero). These losses, credits, and basis in property are tax benefits and for the purpose of these COD rules are called "tax attributes", discussed later.

2. INSOLVENCY (Insolvency Exclusion) – Under this exclusion, you do not have to declare bankruptcy to exclude cancelled debt from income. Under this exception you exclude debt cancellation from your income when you are *in*solvent, and the amount excluded is not more than the amount by which you are insolvent. IRC 108(a)(1)(B). You must use the amount excluded to reduce certain tax attributes, as discussed later. You are insolvent when, and to the extent, your liabilities exceed the fair market value of your assets (the insolvency amount). Determine your liabilities and the fair market value of your assets immediately before the cancellation of your debt to determine whether or not you are insolvent and the amount by which you are insolvent (the insolvency amount). You only exclude from your gross income, debt canceled when you are insolvent, but note, <u>only up to the amount by which you are insolvent</u>. So, if your cancelled debt exceeds the insolvency amount (liabilities less assets), you include in gross income the amount of the debt in excess of the insolvency amount. IRS Publication 908.

<u>EXAMPLE</u>: Your liabilities are $200,000 and the fair market value of your assets is $150,000 equaling an insolvency amount of $50,000 ($200,000 liabilities less $150,000 value of assets). If, in the foreclosure-repossession, the cancelled debt is $75,000, you must include in gross income $25,000 (less the basis of the property). The $25,000 included in gross income is the $75,000 cancelled debt less the $50,000 insolvency amount. If the cancelled debt is $50,000 or less, you do not include any amount in income because you are at or under the $50,000 insolvency amount.

PLANNING TIP: Increase the insolvency amount by increasing liabilities and/or lowering the value of assets -- When the debt to be cancelled is higher than the insolvency amount, there appears to be some room to increase the insolvency amount (and reduce gross income) by either increasing the liabilities and/or lowering the fair market value of assets. However, this planning should not be done in a fraudulent manner. For example, when I say increase the liabilities I mean make sure you account for all of your liabilities including but not limited to liabilities such as credit card debt, car loans, bank loans, credit lines, credit unions, past due property taxes, past due income taxes, personal loans from friends or relatives, accrued interest on debt, and any other debt, secured or unsecured.

On the other side of the equation, when I say about lowering the fair market value of assets, I mean get conservative but honest opinions of value. Establishing a value for an asset is by no means an exact science. It's just as much as an art, and if anything, more so. Typically, three different appraisers will give you three different opinions of value on the same asset. In many cases these differences vary significantly. Accordingly, within reason, there is some latitude in arriving at lower values in your favor.

PLANNING TIP REMINDER: In a foreclosure-repossession Subtract the property's adjusted basis from any debt cancellation amount included in gross income to arrive at the bottom-line net gain or loss –

Remember, in a foreclosure-repossession it's generally not the total debt cancelled on the 1099C that is reported as income. Like any disposition, a foreclosure repossession is a disposition where the net gain is *any* amount of debt canceled less the adjusted basis of the property. Notice I say *any* amount of debt canceled even if it is a partial amount and not the total amount of the debt balance. IRS Publication 523 confirms this by stating, "the full amount of debt *canceled*" (emphasis added on "canceled"); as opposed to stating the "full amount of total debt." Reducing the debt *canceled* by the adjusted basis of the property will reduce any realized gain or create a realized loss. (Rules and examples of gain computations, the tax classification of property, and the character of gain or loss were previously discussed and illustrated in this publication.)

3. FARM DEBT – Another exception where canceled debt may be excluded from income is where the canceled debt is qualified *farm* debt, debt incurred in operating a farm. IRC 108(a)(1)(C); IRS Publication 908. (This will not be discussed here. For further info see Chapter 4 of IRS Pub. 225, Farmer's Tax Guide.)

Reduction of Tax Attributes with Excluded Debt Cancellation Income: If a debtor excludes canceled debt from income because it is canceled in a bankruptcy case or during insolvency, they must use the excluded amount to reduce certain "tax attributes". Tax attributes are certain tax benefits. By reducing these tax attributes (or tax benefits), taxes on the canceled debt is in part postponed instead of being entirely forgiven. This prevents an excessive tax benefit from the debt cancellation. The excluded amount of debt reduces the following tax attributes (or tax benefits): Net operating loss (NOL), General business credit carryovers, Minimum tax credit, Capital losses (such as those from stock losses), Basis of depreciable property (such as rental property), Passive activity loss (such as rental property losses), Passive activity loss credit carryovers, Foreign tax credit. For a further discussion of these tax attributes, refer to IRS Publication 908, *Bankruptcy Tax Guide*, Internal Revenue Code Section 108 and/or IRS Form 982 instructions.

IRS FILING – FORM 982: To use the above situations (bankruptcy, insolvency, farm debt) to exclude cancelled debt from income, file IRS Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*. Attach a statement describing the debt cancellation transaction, including identifying any depreciable property to which a basis reduction* may apply (*covered shortly). Also attach a copy of the 1099C and on the copy insert, "See attached form 982." IRS Form 982 also comes with filing instructions.

INVESTOR TIP: Many home sellers are worried about their tax consequences on these short sales (and they should be). This often causes the seller to be reluctant or hesitant about consummating the transaction. Informing the seller of these tax-reduction strategies is a way to convince the seller to do the transaction and you make money!

IF THE HOME IS DISPOSED OF AT A LOSS: If the home is disposed of at a loss, where the adjusted basis exceeds the amount realized, the loss is not deductible on a personal-use asset such as a residence.

TAX REDUCTION STRATEGIES FOR INVESTMENT PROPERTY OWNERS

Unfortunately, foreclosure repossessions (and the resultant tax consequences) do not just happen to homeowners but also to investment property owners as well. These investment property owners may be frustrated landlords who did not properly educate themselves and did not know how to manage. Or hid did not do their homework and overpaid for the property. Whatever, they consequently cannot make their mortgage payments and lose their property through a foreclosure\short sale.

Again, if the debt cancellation amount exceeds the tax basis of the property (usually the case), then there is a taxable gain. However, unlike most normal sales, where there is cash to be received, a foreclosure disposition results in "phantom income" (the canceled debt), which is *non*-cash income, but subject to tax (unless you employ the tax-reduction strategies of this publication).

<u>STRATEGY 1</u>: DO A 1031 TAX-FREE EXCHANGE - But will a foreclosure disposition hold up as an "exchange"?

<u>ALERT</u>: **This is an important question because many tax advisors and IRS agents will say "no" and thus cause the investment property owner to unnecessary pay taxes. Therefore, at least some property owners will not sell their property to you because of the fear of the tax consequences on the debt forgiveness by the lender. For you this means lost profits from foreclosure bargains.**

GREAT NEWS! It is the author's opinion that a foreclosure disposition qualifies for a 1031 exchange. 1031 experts agree. Skeptics are concerned that because there is no equity (or "net value") in the relinquished property, then there is no exchange. There really is no clear logic to this negative viewpoint. It is still not uncommon for real estate entrepreneurs to acquire (and sell) real estate that is 100% leveraged. As far as the tax law is concerned having equity (or net value) in property is not a requirement for ownership, even with non-recourse mortgages [*Frank Lyon,* 435 US 561 - 1978]. Leasehold interests of 30 years or more (many with little or no equity) qualify for like-kind 1031 treatment, IRS Regulation 1.103l(a)-l(c). The most important factor is that the investor disposes (or acquires) the important *burdens & benefits* of ownership* [see *Karl*, 71 TC 54, 1978]. If this occurs, then there can be a qualifying 1031 exchange.

<u>NOTE</u>: Just because someone is foreclosed on, does not mean they are "broke" or hurting for cash. It could be that the particular property being foreclosed on just did not work out for the investor. The investor still may have resources (cash, financing, partners, etc.) to acquire replacement property in a 1031 exchange. In this scenario, many times the investor and lender will agree to a deed in lieu of foreclosure" (*"DIL"*). That is, the property is deeded back to the lender in lieu of them foreclosing on the property. For more about 1031 exchanges and foreclosures see the back appendix of this publication.

STRATEGY 2 FOR INVESTMENT PROPETY OWNERS: COME UNDER THE SECTION 108 EXCLUSIONS OF INCOME FROM DEBT CANCELLATION

(a) Use Bankruptcy and Insolvency Exclusions - Investment property owners can also use the above bankruptcy and insolvency situations to exclude cancelled debt from income as previously discussed.

(b) Use Section 108(c) Exclusion - Another one of the Section 108 exclusions from income is canceled debt from real property business indebtedness, which is debt connected with rental or business-use real property. IRC 108(a)(1)(D); IRC 108(c). Under this exclusion [called the "section 108(c) exclusion"], the property owner does not have to be filing for bankruptcy, be insolvent or have farm debt. Related to this Section 108(c) exclusion is one of the more common tax attributes, which the property owner can use to reduce -- the basis of depreciable property. Depreciable property means any property subject to depreciation, such as rental or business-use property. You may choose to treat as depreciable property any real property
not normally depreciable property, such as stock in trade or property held primarily for sale to customers in the ordinary course of trade or business (that is, dealer property).

EXAMPLE OF SECTION 108(C) EXCLUSION: An investment property owner, Jim, has rental property debt of $200,000 that is canceled by the lender. Jim owns depreciable property with an adjusted basis of $500,000. Consequently, Jim is able to exclude the entire $200,000 of canceled debt from his gross income by making a 108(c) election to reduce the above property basis of $500,000 by the $200,000 cancelled debt. Such a reduction would bring the property basis down to $300,000. This basis decrease would mean a reduction in tax attributes (or benefits) because the new lower basis of $300,000 (instead of $500,000) means lower future depreciation deductions and a larger gain upon the taxable disposition of the property (which could be deferred by a 1031 exchange). Note that there is a dollar limit on the amount of the Section 108(c) exclusion of debt cancellation up to the depreciable property basis. Beyond this limit, there is a taxable gain. If, in the above example, the canceled debt and Section 108 (c) exclusion was $600,000 (instead of $200,000), the 108(c) reduction of $600,000 would bring the existing property basis of $500,000 down to zero and the remaining excess of $100,000 is not eligible for the 108(c) exclusion but is taxable. As further discussed in the back appendix, this taxable gain could be deferred by a 1031 exchange. In fact, if there were an entire taxable disposition because of a foreclosure-repossession with debt cancellation, the entire gain could be tax deferred with a 1031 exchange, without making a Section 108(c) election, previously discussed under Strategy 1 for investment property owners.

IRS FILING –FORM 982: This is the same as before, IRS Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*. Attach a statement describing the debt cancellation transaction, especially including identifying any depreciable property to which a basis reduction applies. Also attach a copy of the 1099C and on the copy insert, "See attached form 982."

INVESTOR TIP: Many investment property sellers are worried about their tax consequences on these short sales (and they should be). This often causes the seller to be reluctant or hesitant about consummating the transaction. Informing the seller of these tax-reduction strategies is a way to convince the seller to do the transaction and again make more money.

Again, for a further discussion, refer to IRS Publication 908, Bankruptcy Tax Guide and/or Internal Revenue Code Section 108. See also IRS Publication 525, Taxable and Nontaxable Income.

IF INVESTMENT PROPERTY IS DISPOSED OF AT A LOSS: If the investment property is disposed of at a loss, where the adjusted basis exceeds the amount realized, the loss is deductible; special rules apply.

TAX REDUCTION STRATEGIES FOR SECOND HOMEOWNERS

If the foreclosed property was a personal-use second (or vacation) home, there is a catch 22 in that the property owner can not qualify for the Section 121 exclusions of gain, because they did not use the property as their primary residence. On the other hand, the property owner cannot do a 1031 exchange because it's a personal-use property as opposed to a rental, investment or business-use property. (Although some tax advisors take a very aggressive position by claiming, because the property was held for appreciation, it's an investment property and thus would qualify for a 1031. Without planning in advance and knowing the law, this is a wrong approach.

STRATEGY 1 FOR SECOND HOMEOWNERS: COME UNDER THE BANKRUPTCY OR INSOLVENCY EXCLUSIONS FOR INCOME FROM DEBT CANCELLATION - As previously discussed.

STRATEGY 2 FOR SECOND HOMEOWNERS: LOOK FOR TAX LOSSES OR DEDUCTIONS TO REDUCE TAXABLE GAIN – For a further discussion of this, See Tax Reduction Strategy for All Property Owners below.

DISPOSED OF AT A LOSS: If the second home is disposed of at a loss, where the adjusted basis exceeds the amount realized, the loss is not deductible on a personal-use asset such as a second home.

TIP: Convert the property to a rental property before the foreclosure-disposition by actually renting the property.

TAX REDUCTION STRATEGY FOR ALL PROPERTY OWNERS -- HOME OWNERS AND INVESTMENT PROPRTY OWNERS

If the homeowner or investment property owner cannot use (or fully use) any the above strategies, then - **Look for tax losses or deductions to reduce taxable gain** - For example, any loser stocks or bonds that can be sold by the end of the year will generate capital losses which can be used to fully offset capital gains from real estate. (If you like the stock or bond, you can buy it back in 31 days under the wash-sale rules). Also, a rental property loss, business loss, retirement plan contribution and many other deductions can too offset the gain. This strategy could be done by itself, or in conjunction with the other strategies of this publication.

APPENDIX: How Investment Property Owners Can Avoid Debt Income with the 108 (c) Exclusion and A 1031 Tax-Free Exchange

As previously discussed, one of the Section 108 exclusions from income is canceled debt from real property business indebtedness, which is debt connected with rental or business-use real property. IRC 108(a)(1)(D); IRC 108(c). Under this exclusion [called the "section 108(c) exclusion"], the property owner does not have to be filing for bankruptcy, be insolvent or have farm debt. Related to the Section 108(c) exclusion is one of the more common tax attributes that an investor can use -- reduce the basis of depreciable property. Depreciable property means any property subject to depreciation, such as rental or business-use property. You may choose to treat as depreciable property any real property that is stock in trade or is held primarily for sale to customers in the ordinary course of trade or business (that is, dealer property).

Note that there is dollar limit* on the amount of the Section 108(c) exclusion of debt cancellation. Beyond this limit there is a taxable gain (or loss). This is discussed below.

***Dollar Amount Limitations of the 108(c) Exclusion**: The amount of debt cancellation income that may be excluded is subject to two limitations:

(i) A fair market value (FMV) limitation, and

(ii) An aggregate depreciable basis limitation.

The formula to compute the 108(c) exclusion is:

1. Determine the outstanding principal balance of the debt at the time of the debt cancellation.

2. Determine the FMV of rental or business-use real estate at the time of the cancellation.

3. Subtract 2 above from 1 above. This is the amount that can used to reduce aggregate depreciable real property basis, if available.

4. Determine the total aggregate basis of depreciable business real property owned by the taxpayer (including the property securing the debt to be canceled).

5. Take the lesser of 3 or 4. This is the amount eligible for the 108(c) exclusion.

6. Any excess of 1 over 5 is not eligible for the 108(c) exclusion and is includable in income, unless there is other depreciable property basis to reduce. (Note: In a foreclosure-disposition any excess income not eligible for the 108(c) exclusion could be eligible for another non-recognition provision such as a 1031 tax-free exchange, discussed shortly).

EXAMPLE: BB owns an apartment building with an outstanding mortgage balance of $3,000,000. The property is now worth $2,000,000. (Assume BB is solvent, is not filling for bankruptcy and this is not farm debt). The property has an adjusted (depreciable) basis of $900,000. The property is foreclosed on and the $3,000,000 of property debt is canceled. Assume the above debt balance, fair market value and basis are the amounts at the time of the debt discharge. Applying the above formula, the 108(c) exclusion is $900,000 as follows:

1. $3,000,000 - Outstanding principal balance of canceled debt at the time of debt cancellation.

2. - 2,000,000 - FMV of the business real estate at the time of the cancellation.

3. =1,000,000 - Subtract 2 above from 1 above. This is the amount that can used to reduce aggregate depreciable basis, if available.

4. $900,000 - The total aggregate basis of depreciable business real property owned by the taxpayer (in this case, the only depreciable property available is this property securing the debt to be discharged)

5. $900,000 – This is the lesser of 3 or 4. The amount eligible for the 108(c) exclusion. Therefore, BB can make the 108(c) election to reduce the basis by the Section 108(c) exclusion of $900,000. The basis of the property would then be zero, $900,000 less $900,000.

TAX ALERT: The 108(c)-basis reduction (here, $900,000) is subject to 1250 recapture, meaning that it will be taxed entirely as ordinary income and not capital gain. However, it can be deferred via a 1031 exchange, discussed shortly.

6. $2,100,000 - Excess of 1 over 5 is not eligible for the 108(c) exclusion and is therefore taxable; but see the planning strategy below.

STRATEGY: DO A 1031 TAX-FREE EXCHANGE. The above $2,100,000 is not eligible for the 108(c) exclusion. It could be eligible for another non-recognition provision such as a 1031 tax-free exchange. In this case BB would have to follow the rules for a 1031 exchange. If BB timely acquires a like-replacement property within the guidelines of 1031 for $2,100,000 (or greater), BB will have totally deferred the substantial tax liability on the foreclosure-disposition of the apartment building. Any lesser amount would be taxed in a move-down exchange as taxable boot.

The referenced sections are from ***The Renaissance Goldmine of Goldmine of Brilliant Tax Strategies Real Estate Investor's*****, A Tax Reduction Software System by Albert Aiello & Bill Noll. For more info go to https://TractionREIA.com/al**