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Tax Consequences of Cancellation of Debt for Real Estate

August 23, 2011

1. Requirements of Internal Revenue Code.

   a. Gross income includes "income from discharge of indebtedness." Internal Revenue Code (IRC) § 61(a)(12).

   b. Creditor must issue IRS Form 1099-C (Cancellation of Debt) to a taxpayer that settles a debt or has a debt written off that is in excess of $600.

   c. Taxpayer must file IRS Form 982 to reduce any tax owed on the cancellation of debt.

2. Recourse debt vs. non-recourse debt with the purchase of real estate.

   a. Recourse debt is debt for which a debtor is personally liable. This means that if a lender forecloses and takes property that is mortgaged and the property is worth less than the amount owed under the mortgage (which would also include the legal fees and costs of foreclosure), the lender can get a personal judgment (or deficiency judgment) against the borrower for the shortfall between the value of the property and the amount owed under the mortgage.

      i. Tax owed would most likely be ordinary income tax for the difference between the fair market value of the property and the amount of debt cancelled.

   b. Non-recourse debt involves a loan for which the lender's only remedy in case of default is to repossess the property being mortgaged. Stated another way, in a non-recourse type of loan, the lender cannot elect to pursue the borrower personally in case of default. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in cancellation of debt income. However, it may result in a capital gains tax if the amount of debt forgiven exceeds the borrower's tax basis in the property.

i. Tax owed would most likely be capital gains tax for amount of debt cancelled in excess of the property's tax basis.

3. Exceptions to Cancellation of Debt Income.

a. Discharge of indebtedness in a title 11 case (bankruptcy).

If the borrower files bankruptcy before the debt is written off and the 1099-C is issued, there is deemed, by operation of law, to be no income to declare.

b. Discharge of indebtedness to the extent insolvent.

A taxpayer is insolvent when their total liabilities exceed the fair market value of assets. For example, if a taxpayer has $200,000 in liabilities, but only $100,000 in assets, they are considered insolvent under the Internal Revenue Code. Therefore, a cancellation of a $50,000 debt will not need to be reported as gross income. However, if a debt of $150,000 was cancelled, the taxpayer will have $50,000 in gross income because their total liabilities no longer exceed their total assets (cancelling $150,000 in debt means the taxpayer now has only $50,000 in liabilities).

For corporations, insolvency is determined without regard to the financial condition of the corporation's shareholders. However, in the case of a partnership (which would include most LLCs), insolvency is determined at the individual partner level. Therefore, although a partnership may be insolvent, the cancellation of debt income can still result in taxable income if the individual partners are solvent.

c. Discharge of qualified farm indebtedness.

A taxpayer has qualified farm indebtedness if such indebtedness was incurred directly in connection with the taxpayer's trade or business in farming; and 50% or more of the aggregate gross receipts of the taxpayer for the three (3) taxable years preceding the discharge is attributable to the trade or business of farming.

d. Discharge of qualified real property business indebtedness.

This applies when the indebtedness was incurred or assumed in connection with real property used in a trade or business; provided that it was either: i) incurred or assumed prior to January 1, 1993, or ii) incurred or assumed to acquire, construct, reconstruct, or substantially improve the real property used in a trade or business; and the taxpayer elects to apply this exception. This exception only reduces the basis of the depreciable real property of the taxpayer

e. Discharge of qualified principal residence indebtedness.

The Mortgage Forgiveness Act of 2007 (as extended) applies to residential (owner-occupied) homeowners of real estate who had the debt written off or restructured during the 2007 to 2012 calendar years. Rental properties, second homes, and vacation homes do not qualify under the Act. The Act protects a homeowner from debt cancellation up to $1,000,000 or up to $2,000,000 for a married couple. Further, to qualify under the Act, the forgiven loan must have been used exclusively for home purchase or improvement. Money from a home equity line of credit used for other purposes (such as to pay off credit cards or to buy a vehicle) would not apply.

4. Short Sales vs. Deeds in Lieu of Foreclosure. With an eye to minimizing the credit damage that a foreclosure can cause, a homeowner may consider alternatives, such as a short sale or a deed in lieu of foreclosure.

   a. In a short sale, a borrower can, with the lender's approval, enter into a sale of real property for less than the amount due on the loan. If the lender forgives the shortfall, the cancellation of debt could result in taxable income. To avoid that consequence, the borrower might give the lender a promissory note for the balance.

   b. A deed in lieu of foreclosure is an agreement between the borrower and the lender where the borrower deeds the property to the lender in satisfaction of the outstanding debt. The general language of such an agreement almost always provides that the value of the property is equal to outstanding obligation, thereby allowing the borrower to escape any tax liability arising from cancelled debt. However, lenders may require a confession of judgment for any deficiency, which could be cancellation of debt in ten (10) years when the judgment expires.

5. Deferral of cancellation of debt income tax for businesses is possible for certain reacquisitions of debt under American Recovery and Reinvestment Act of 2009.

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