Common Foreclosure and Cancellation of Debt Issues for Real Property

Yvonne McDuffie-Williams: Thank you. As he said, my name is Yvonne McDuffie-Williams. I am a senior program analyst with the Small Business/Self-Employed division within the Internal Revenue Service. Welcome to today’s presentation titled Common Foreclosure and Cancellation of Debt Issues for Real Property. This presentation is designed for common foreclosure and cancellation of debt issues faced by individuals and sole proprietorships who owned real estate property disposed of through a foreclosure or similar disposition and those who received a loan modification. At the end of this learning experience, you will be able to explain to your clients the proper tax treatments for foreclosures and canceled debt related to their principal residence, business property, and investment property.

During this presentation, I will: review some common terms; define cancellation of debt income; explain the difference between nonrecourse and recourse debt; discuss the exclusions that are specifically available for individuals and sole-proprietorships under Internal Revenue Code section 108, which is titled Income from Discharge of Indebtedness; discuss the tax treatment for principal residences, real estate property used in a business, real estate property held for investment; and lastly, I will provide an overview of nonrecourse/anti-deficiency state laws. I hope you will find this presentation both helpful and informative. Everything I talk about today in forms, publications, and instructions is found on our website, IRS.gov.

Let’s go over a few terms. A foreclosure is a legal procedure by which mortgaged real estate property is sold by the lender in full or partial satisfaction of a mortgage debt.

A short sale is 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. The borrower and the lender generally enter into a short sale agreement.

A deed in lieu of foreclosure is when a borrower returns mortgaged property back to the lender in full satisfaction of the mortgaged outstanding debt balance upon an agreement with the lender.

An 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 or her ownership and does not pass it on to anyone else. An abandonment may lead to foreclosure proceedings in order for the lender to obtain legal possession of the property.
Property secured by recourse debt is not a sale of the property until the actual foreclosure sale occurs; whereas property that is secured by nonrecourse debt is considered a sale upon the foreclosure or an abandonment that is acknowledged by the lender. Throughout the presentation, I will use the term foreclosure, which will also represent short sales, deed in lieu of foreclosures, and abandonments where nonrecourse debts secured the property.

These transactions are all considered sales of real property for federal tax purposes. The type of disposition does not change how the gain or loss is determined. Further, cancellation of debt income is determined by the type of loan that secures the property, and I will discuss the type of loan shortly.

Let’s talk about cancellation of debt income. When an individual receives a loan, those loan proceeds are non-taxable, but as soon as some or all of those loan proceeds become forgivable where the taxpayer is no longer liable to repay that debt, the taxpayer now has cancellation of debt income (or CODI). Under Internal Revenue Code section 61(a)(12), gross income includes income from canceled debt.

We look at the origin of the canceled debt to determine where that cancellation of debt income is reported on the tax return. If the canceled debt is non-business debt, it is reported on Form 1040, Line 21 as other income. If that canceled debt is related to sole proprietorship or farm business, it is reported on Schedule C or Schedule F. If that canceled debt is related to non-farm rental activity, it is reported on Schedule E as additional rental income.

CODI is generally passive income if generated by a passive activity. Lastly, canceled debt related to a farm rental activity is reported on Form 4835, Farm Rental Income and Expenses. There are exceptions to Code section 61(a)(12), and I will just mention three: these are gifts, deductible debt, and the reduction of purchase price of the property. In these situations, forgiven debt is not taxable. These exceptions apply before any exclusion – which I will discuss later – and do not require the reduction of any tax attributes.

We all know what gifts are. For deductible debt: if a taxpayer had mortgage interest that they would have paid and it would have been deductible on the tax return, then any canceled mortgage interest is not taxable, and that falls under one of the exceptions. And the third exception that I mentioned is when the purchase price of the property is reduced by the seller. So, in that circumstance, the seller will reduce the purchase price of the property, and at the same time, the buyer reduces the basis of the property. In contrast, if the bank or financial institution that holds the mortgage reduces or modifies
that mortgage, then any canceled debt related to that mortgage is taxable because the lender forgave that canceled debt.

Under section 108 Income from Discharge of Indebtedness, a taxpayer may be able to qualify to exclude CODI. Five exclusions that are applicable to an individual or sole proprietorship: bankruptcy, insolvency, the qualified farm indebtedness, the qualified real property business indebtedness, and then the qualified principal residence indebtedness exclusion.

These five exclusions do not apply to any gain realized from a disposition via a foreclosure, and I will discuss each one of these a little later. The type of loan will determine the amount realized to calculate the gain or loss from the foreclosure and whether cancellation of debt income must be reported on the tax return.

Under nonrecourse debt, a debtor is not personally responsible to repay that debt, so what happens is that, at a foreclosure, the lender merely repossesses the property, which satisfies that debt. The gain or loss is considered under section 1001 of the Internal Revenue Code, the Determination of the Amount of the Recognition of Gain or Loss, and it is calculated as the greater of the outstanding principal balance or the fair market value of the property less the adjusted basis.

The adjusted basis is the cost of the property increased by certain amounts, such as settlement costs and property improvements. Damages to the property that were not remedied will decrease the basis of the property, and you may refer to Publication 523, Selling Your Home, for more information.

When property is foreclosed, there is generally no cancellation of debt income when the debt that secured the property was nonrecourse. So, when the taxpayer’s debt is nonrecourse, the taxpayer can just simply walk away from the property, and they are not liable to pay any of the outstanding debt. However, if the taxpayer received a loan modification, for example, then that canceled debt is taxable under section 61(a)(12) and that is because the taxpayer continues to own that property.

Debt that is secured by the property that is recourse debt – the taxpayer is personally responsible to repay the outstanding balance of that debt. So, any cancellation of debt that relates to that recourse debt is taxable. To determine our cancellation of debt income, we look at the outstanding debt balance less the fair market value. The gain or loss is determined under section 1001, such as nonrecourse debt, and we look at the lesser of the fair market value or the debt balance less the adjusted basis.

Remember, under nonrecourse debt for the amount realized, we looked at the greater of the outstanding loan balance or the fair market value. So, for
recourse debt, we are looking at the lesser of the fair market value or the outstanding debt balance at the time of the foreclosure sale. Okay, for recourse debt, we actually look at the foreclosure sale to determine the outstanding loan balance and any deficiency balance. We look at the foreclosure sale to determine the cancellation of debt income.

For recourse debt, the debt is not complete until the actual sale of that property, and generally to a third party; but each situation may be different depending on the state of where that property is located. For recourse debt, the taxpayer may continue to owe a balance (such as for taxes, interest, and insurance on that property), so it is not until that foreclosure sale that we are able to really determine any deficiency balance. And that is when the lender will determine, based on state law or local law, whether to forgive that debt or to pursue a deficiency balance.

A lender will issue a Form 1099-A, titled *Acquisition or Abandonment of Secured Property*, when the lender forecloses on that property or they acknowledge that the taxpayer has abandoned that property. A taxpayer cannot just simply walk away from the property. They may continue to be liable for that property because the lender has not acknowledged that that property has been abandoned.

The type of loan will determine the year of the disposition. I just want to highlight a few of the boxes of the form. Box 1 will identify the lender’s acquisition date, which would be the foreclosure date, for example, or the acknowledgment of the abandonment of that property.

Box 2 will identify the balance of the outstanding loan at the time of the acquisition or acknowledgment of abandonment of that property. Box 4 will identify the fair market value of that property. Box 5 will identify whether the taxpayer is personally liable to repay that outstanding debt or not. If there is a checkmark or an “X” in that box, it means the taxpayer is personally liable to repay that outstanding debt and that debt is recourse debt. If that box is blank or empty, then generally it means that that taxpayer is not personally liable to repay the debt and the debt is nonrecourse debt. The Form 1099-A should reconcile with the taxpayer’s records.

A lender will issue a Form 1099-C when the lender cancels debt, so Box 1 will identify the date that the lender cancels the debt. Box 2 will identify the amount of debt that is canceled. The amount in Box 2 is the amount that we are looking for on the tax return as either taxable or excludable, and I will talk about how to report the excludable amount.

Box 3 will identify the interest that is included in Box 2, so that goes back to one of the exceptions that I mentioned earlier, the deductible debt. If the
taxpayer had mortgage interest that was canceled and it is reported in Box 3, then that amount is not cancellation of debt income, so that falls under one of the exceptions because the taxpayer could have deducted that mortgage interest on their tax return had they paid it.

Now, keep in mind because the taxpayer did not pay that mortgage interest, that mortgage interest is not deductible on the tax return. It is only excludable as cancellation of debt income that is reported on Form 1099-C, Box 3. If there is an amount in Box 3, it should be deducted from Box 2, because Box 2 identifies canceled debt and the amount in Box 2 includes the mortgage interest, for example.

Moving on: Box 5 will identify whether the taxpayer is personally liable to repay that debt or not. Box 5 is similar to Form 1099-A. If there is a checkmark or an “X” in that box, it means the taxpayer is personally liable to repay the debt, and it is recourse debt. If that box is blank, then generally it means that debt is nonrecourse debt, and the taxpayer is not personally liable to repay the debt. The Form 1099-C and A should reconcile with the taxpayer’s records, and if the taxpayer believes that the information reported on these forms is incorrect, then they should contact the lender to issue a corrected Form 1099-A or C.

A lender is not required to issue both a 1099-A and C when the foreclosure and the cancellation of debt occurs in the same year, but sometimes lenders erroneously may not issue a borrower a Form 1099-A or C. For example, a 1099-C may be issued only for the first mortgage that secures the property and may not be issued for the second debt that secured the property. So, sometimes the taxpayer would need to look at public records to identify the foreclosure sale, especially when it relates to recourse debt; and also it is imperative for the taxpayer to maintain their records regarding their loan and any property information that they have related to their property. If a taxpayer does not receive a Form 1099-C, they are still required to report that cancellation of debt income on their tax return. And this is similar to a taxpayer who is a wage earner who did not receive a W-2 for their wages; they are still required to report their wages on their tax return.

As I alluded, there could be potential timing differences between nonrecourse and recourse debt. For nonrecourse debt, the taxpayer would report the disposition at the time of the foreclosure, which would correlate to the Form 1099-A, or if the lender acknowledges abandonment of that property. If the debt was recourse debt that secured the property, then the taxpayer would report that disposition at the time of the foreclosure sale. That sale may be different than that 1099-A that is issued. For example, a taxpayer’s property is foreclosed in 2014, but the sale does not occur until 2015. So, in that circumstance where there is a recourse debt that secured the property, the taxpayer will report the disposition in 2015, not in 2014.
Cancellation of debt income would also be reported unless the taxpayer was able to exclude cancellation of debt income under section 108. So, we must look at the series of events. We identify the series of events that occurred before, during, and after that foreclosure to determine whether or not (or when) that taxpayer should report the disposition of the property or any cancellation of debt income.

For the fair market value for recourse debt, we look at what a willing party would pay (a third party would pay) for that property, and we generally look at the foreclosure sale. I will go through an example later about that. So, the sale would determine the fair market value of that property, and that is imperative for recourse debt when you are determining the disposition of that property.

Let’s move on to the five exclusions under section 108 where a taxpayer may be able to exclude CODI. As I stated earlier, there are five exclusions and these five exclusions are discussed in Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments for Individuals. When a taxpayer excludes CODI on their tax return, they must attach a Form 982 titled Reduction of Tax Attributes Due to Discharge of Indebtedness (And Section 1082 Basis Adjustment).

The five exclusions include bankruptcy. Under the bankruptcy exclusion, this is the first exclusion, and it takes precedence over all the other exclusions. This is not an election. The taxpayer must be in bankruptcy proceeding and the debt is discharged by court or pursuant to a plan approved by a court. So, just merely filing for bankruptcy does not qualify under this exclusion.

The second exclusion is the insolvency exclusion. This is not an election. Under the insolvency exclusion, the taxpayer is insolvent to the extent that the outstanding debt that they owe is more than the fair market value of the assets owned right before the canceled debt. State tax-exempt assets are included in the calculations, contingent liabilities are excluded, and any CODI that exceeds the amount of the taxpayer’s insolvency is taxable. An insolvency worksheet is located in Publication 4681, and our real estate foreclosure and cancellation of debt audit technique guide (that we recently posted on IRS.gov) includes several examples of insolvency calculations and also the other exclusions.

The third exclusion is the qualified farm indebtedness. The bankruptcy and insolvency exclusions take precedence over this exclusion. This is not an election. The discharge of debt must be made by a creditor who regularly engages in the business of lending money and the lender cannot be related to the farmer. Generally, this exclusion allows a taxpayer who is in the
business of farming to reduce tax attributes instead of recognizing
cancellation of debt income.

The fourth exclusion is the qualified real property business exclusion. This
is an election, so the taxpayer must attach the Form 982 to their tax return to
elect this exclusion. A taxpayer must attach the Form 982 to a timely-filed
tax return. If a taxpayer does not do that, then they may file an amended
return within six months of the original due date of the return, and that
excludes any extensions. If neither one of those actions are taken, then the
taxpayer must request a private letter ruling, and we have more information
on IRS.gov.

If the debt is discharged for property used in a trade or business other than a
C corporation taxpayer, a taxpayer may be eligible to exclude CODI from
income under this exclusion. An example of real estate property used in a
trade or business is a person who owns the property where they also operate
their retail store.

The last exclusion is the qualified principal residence indebtedness
exclusion, and this is a common exclusion that is used to exclude CODI.
This is not an election. Under this exclusion, income from the discharge of
qualifying debt used to buy, build, or substantially improve a taxpayer’s
qualified principal residence (also known as their main home) may qualify
to be excluded under this exclusion.

Any debt used for other purposes is not qualifying debt under this
exclusion. Debt reduced through mortgage restructuring, as well as
mortgage debt forgiven in connection with a foreclosure, for example,
qualifies for this exclusion. The exclusion is only available for debt that is
discharged between the years of January 1, 2007, through December 31,
2014. A taxpayer may be able to exclude up to $2 million (or $1 million for
married filing separate filing status).

The canceled debt must relate to the decline in the value of the taxpayer’s
main home or a decline in their financial situation; so, we have seen
throughout the past few years that our market values of most property in the
United States has declined, but it is increasing. The two out of five-year
ownership test under Internal Revenue Code 121 regarding the exclusion of
gain from the sale of one’s principal residence does not apply under this
exclusion, and there is some confusion about that.

So, let me just explain a little bit. A taxpayer may live in their home for two
years or less and qualify under this exclusion. Again, section 121 does not
apply under this exclusion. This exclusion (the principal residence) does not
apply to a second home, investment property, or a business property.
Remember, the debt proceeds must be used to acquire, construct, or
substantially improve the taxpayer’s main home. For example, if the debt of one’s main home was refinanced and the closing costs are rolled into that loan, then those closing costs do not qualify under this exclusion. Therefore, the portion of the loan attributable to the refinanced closing costs does not qualify under this exclusion.

Just to summarize the qualified principal residence exclusion: any amount of the outstanding debt associated with the taxpayer’s main home that was not used to acquire, build, or substantially improve their principal residence or debt that exceeds $2 million (or $1 million for married filing separate) does not qualify under this exclusion. I will discuss the tax treatment of the qualified principal residence a little later.

Note that Internal Revenue Code section 108 only applies to cancellation of debt income. It does not apply to any gain that is realized from the disposition of property. Again, you can refer to Publication 4681 for more information on these five exclusions.

When a taxpayer excludes CODI from gross income, they are required to reduce certain tax attributes, and each exclusion has its own tax attribute rules. Due to time, I am not going to go into detail, but I will give you an overview of the rules. And again, you can refer to our Publication 4681 for more information, and then our recently-posted foreclosure and cancellation of debt audit technique guide includes several examples of each exclusion, including the tax attribute reduction rules.

The reduction of tax attributes is a means of deferring CODI to the future when it is excluded in the current year. The reduction of tax attributes is reported on Form 982 titled Reduction of Tax Attributes Due to Discharge of Indebtedness (And Section 1082 Basis Adjustment), which should be attached to the tax return. Before any tax attributes are reduced, taxable income is calculated first for the year of discharge.

Generally, tax attributes are reduced on the first year following the year that the taxpayer excludes CODI. For example, if a taxpayer excludes CODI in 2014, then they would generally reduce their tax attributes on January 1, 2015, for a sole proprietor or individual taxpayer. Under the bankruptcy and insolvency exclusions, the same tax attributes are reduced. A reminder under the bankruptcy exclusion: merely filing for bankruptcy does not qualify for this exclusion.

An insolvent taxpayer is one whose liabilities exceed the fair market value of their assets right before the date of the discharge of debt. Under the farm exclusion, there are certain limitations that are applied first, and then the same tax attributes under the bankruptcy and insolvency exclusions are reduced. These tax attributes are not reduced below zero.
The tax attributes for the bankruptcy, insolvency, and farm are: the net operating losses (these are reduced first); then, the general business credits (and any carryover is reduced by 33-1/3 cents for each dollar of excluded canceled debt); then, the minimum tax credit is reduced (and the minimum tax credit is reduced by 33-1/3 cents for each dollar of excluded debt); then, capital losses are reduced; then, the basis of any property held is reduced (keep in mind, depending on the taxpayer’s situation, they may be required to reduce personal assets); then, the passive activity loss and credit carryovers are reduced (credit carryovers are reduced by 33-1/3 cents for each dollar of excluded canceled debt); and then lastly, the foreign tax credits are reduced (and any carryovers are reduced by 33-1/3 cents for each dollar of excluded canceled debt).

As a reminder, a taxpayer may qualify to exclude CODI under the qualified real property business exclusion when a timely election is made and the debt is canceled for property used in a trade or business. Under the qualified real property business exclusion, the taxpayer must first determine the amount of CODI that is allowed to be excluded. Once that amount is determined, then the basis of depreciable real property is reduced, not below zero, and then any remaining depreciable property is reduced.

And again, that reduction takes place on the first day following the year that the taxpayer excludes CODI from gross income. The taxpayer must attach the Form 982 and complete Parts I and II of the form. There is a special rule under this exclusion. If the taxpayer excludes CODI in the same year that they dispose of that property, then they must immediately reduce the basis of that property. Disposition gain or loss of that property will include that reduced basis of that property.

Under the qualified principal residence exclusion, when a taxpayer excludes CODI, then they must reduce the basis of their principal residence in the same year. However, if a taxpayer is discharged of debt, after they dispose of the property, then they are not required to reduce the basis of their principal residence (and that is because they no longer own the property). And again, more information is found in Publication 4681 and the foreclosure and cancellation of debt audit technique guide.

Let’s move on to the tax treatment of the principal residence, business property, and investment property, which pretty much summarizes the rules that I discussed. Under the principal residence exclusion, the taxpayer may be able to exclude cancellation of debt income when it relates to their principal residence and its qualified debt. Remember the two out of five-year ownership does not apply under this exclusion, so a taxpayer may live in their home for two years or less and may be able to qualify for this exclusion.
The taxpayer would attach the Form 982 to their tax return and complete Parts I and II. Part I will identify the exclusion that they are excluding CODI. Line 2 will identify the amount of CODI that is being excluded from their gross income. Part II will identify the basis reduction of their principal residence. A taxpayer who reduces their basis in their principal residence is one who receives a loan modification, for example.

A taxpayer who no longer owns their home and received discharge of debt after they dispose of their property is not required to reduce the basis of their property, so they will not complete Part II of this form. The taxpayer who disposes of their property who has a principal residence would report the disposition on Form 8949, Sales and Other Dispositions of Capital Assets, and Schedule D, Capital Gains and Losses.

Under IRC section 121 Exclusion of Gain from the Sale of the Principal Residence, if the taxpayer used their main home for at least two out of the five years before the disposition (and they also meet other requirements), they may be able to exclude up to $500,000 (or $250,000 for married filing separate) of the gain from the foreclosure or the foreclosure sale. That is when section 121 would apply to the gain. If you have any additional questions regarding the sale of property, you can refer to Publication 523, Selling Your Home, for more information.

When canceled debt relates to real estate property used in a trade or business, the cancellation of debt income may be excluded under the bankruptcy and/or the insolvency exclusions. They also may be able to exclude CODI under the farm and the qualified real property business exclusion. The bankruptcy exclusion takes precedence, and then the insolvency, and then the farm, and then the qualified real property business exclusion. A taxpayer who is a farmer must consider the farming exclusion before considering the qualified real property business exclusion.

The taxpayer would attach the Form 982 and complete Parts I and II. Part I will identify the exclusion that the taxpayer is excluding CODI, Line 2 will identify the amount of CODI being excluded from gross income, and Part II will identify the specific tax attributes and the amounts related to the reduction of those tax attributes.

The disposition is reported on Form 4797, Sale of Business Property. The character of the gain, such as ordinary or capital treatment, is determined by the character of the property. And again, you may refer to Publication 4681 for more information about the tax attribute reduction rules and the exclusions.
When canceled debt relates to real property used for investment purposes (such as vacant land held for appreciation), the canceled debt may be excluded under the bankruptcy and/or insolvency exclusions. Again, the bankruptcy exclusion takes precedence over the insolvency exclusion. The taxpayer would attach the Form 982 just as they would with the other exclusions and complete Parts I and II. Part I will identify the exclusion for the CODI that is being excluded. Line 2 will identify the amount of CODI that is being excluded, and Part II will identify the specific tax attributes that are being reduced under those specific exclusions. A taxpayer will report the disposition on Form 8949 and Schedule D. Just keep in mind that any losses related to investment property are limited to $3,000 a year.

Let’s go over an example to solidify what I have been discussing. Chris purchases a second home for $200,000. She paid $15,000 down and borrowed the remaining $185,000 from the bank. Chris is personally liable for the loan, so it is recourse debt. Chris later faced financial difficulty, so the lender foreclosed on the property. On the same day the lender foreclosed on the property, they sold the property to a third party for $170,000. They also relieved or canceled $10,000 of Chris’ outstanding debt balance. Let me just repeat those numbers. She purchased a home for $200,000. That is her basis in the property. The debt outstanding at the time of the foreclosure and foreclosure sale was $180,000. The lender forgave her of $10,000 of the debt. We determine our cancellation of debt income, which would also correlate or it should correlate with the Form 1099-C of $10,000, and we take our outstanding debt balance at the time of the foreclosure sale less the fair market value of the property.

The fair market value, again, is the fair market value that was paid by a third party, which was $170,000, and that leaves us with ordinary cancellation of debt income of $10,000. Chris would report that $10,000 on her tax return on Form 1040, Line 21, as other income. If Chris qualified to exclude CODI, she would look to the bankruptcy and/or the insolvency exclusions to exclude $10,000 from her gross income, and she would attach the Form 982 identifying that she is excluding cancellation of debt income under one or both of those exclusions.

Keep in mind that there’s two parts to the reporting of cancellation of debt income and the disposition of property, and sometimes there is confusion about that. So, you have this cancellation of debt income piece, then you have the disposition piece. Cancellation of debt income, remember, is taxable unless the taxpayer can exclude it under section 108 or it meets one of the exceptions that I mentioned.

The second piece is the disposition. The disposition is calculated as the lesser of the outstanding debt balance at the time of the foreclosure sale or
the fair market value of that property. In this example, the outstanding debt was $180,000 at the time of the sale, and the fair market value, which was the purchase price of that property by a third party, was $170,000. So, our amount realized is $170,000 that we are going to use as our sales price.

The adjusted basis was $200,000, which was the purchase price of her property. She did not have any increases or decreases to the basis of her property. And that leaves us with a loss of $30,000. That loss is non-deductible because it relates to her second home, which was personal property. Losses from personal property are non-deductible. Chris would report the disposition on Form 8949, *Sales and Other Dispositions of Capital Assets*, and Schedule D, *Capital Gains and Losses*. The instructions identify how to report a non-deductible loss.

The last topic I will address is an overview of nonrecourse and anti-deficiency states. The identification of the loan that secures real estate property, whether it is nonrecourse or recourse for federal tax purposes, is governed by the state of where that property is located. So, it is important to identify and understand what the state laws are in that particular state of where that property is located.

Different states have different rules or definitions of nonrecourse debt. I will give you an example. If a taxpayer owns several properties and those several properties are owned in a state that is identified as nonrecourse or anti-deficiency state, then depending on that state, some of those properties may meet the definition of nonrecourse. And for federal tax purposes, it would be treated as nonrecourse. Depending on the taxpayer’s situation, if the taxpayer had a loan modification, for example, then CODI would be taxable. If they dispose of that property through a foreclosure, for example, or a short sale, they no longer own that property and it is nonrecourse debt, then the taxpayer, again, is not required to report any CODI on their tax return.

Some states look at different aspects, so some states look at the type of loan, the number of acres, how that property is used (so, the number of dwelling units), and even the date or the type of loan. Again, it is important to identify the state of where that property is located and understand the definition of nonrecourse debt for that state.

For anti-deficiency states, an anti-deficiency state is one where, generally, the lender cannot pursue a deficiency judgment in court. We often think that if a state is defined as nonrecourse or anti-deficiency, then all notes are nonrecourse. As I stated, this is not correct. Again, it is important to identify exactly what the laws are in that particular state. Some examples of nonrecourse or anti-deficiency states – and there are others, I’ll just give you a few – are Alaska, Arizona, California, and Connecticut.
I have covered a lot of information during this presentation, so I just want to highlight a few points. The amount of canceled debt must be included in gross income unless the debt is related to a gift, deductible debt, when the purchase price of the property is reduced by the seller, or the taxpayer qualifies to exclude CODI under one of the five exclusions that I discussed. Cancellation of debt income is reported as other income on the respective form depending on what that debt related to.

It is important to identify the series of events that occurred before, during, and after the disposition. The Form 1099-A will identify whether there is a foreclosure or the lender acknowledges abandonment of that property, and then the 1099-C will identify the cancellation of debt income.

Under the principal residence exclusion, the taxpayer may be able to exclude cancellation of debt for their principal residence. Keep in mind that the two out of five-year under section 121 does not apply under this exclusion, so a taxpayer may live in their home for two years or less and be able to exclude cancellation of debt income related to their principal residence. The only exclusion that is an election is the qualified real property business exclusion. It is imperative that the Form 982 be attached to the tax return.

We have multiple resources available for you related to this topic. We do have a one-stop site, which is our Real Estate Tax Center. It includes tips on information on topics such as tax credits, rental income and expenses, and the sale of a residence. It includes frequently asked questions and information on real estate tax issues, and then it also includes information on how to avoid tax schemes related to real estate property, and then it has a section on trends and statistics. Earlier this year, we posted our Real Estate Foreclosure and Cancellation of Debt Audit Technique Guide, which is posted on IRS.gov, and throughout the presentation, I referred to Publication 4681. Other resources include Publication 544, Sales and Other Dispositions of Assets, and Publication 523, Selling Your Home.

I want to thank you for attending this presentation on common foreclosures and cancellation of debt issues for real property.

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**Glossary**

**Abandonment** – This 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.

**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.

**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.

**Foreclosure** – A legal procedure by which mortgaged real estate property is sold by the lender in full or partial satisfaction of the mortgage debt.

**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.

**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.
Index

A
Abandonment, 1-2, 5, 13, 14

C
Cancellation of debt income
  Definition, 14
  Exclusions under IRC section 108, 6-8
  Overview, 2-3

D
Deed in lieu of foreclosure, 1-2, 14

F
Foreclosure
  Definition, 14
  Example of, 11-12
  Overview, 1-3, 5-6
  Form 1099-A, 4-5, 13
  Form 1099-C, 4-5, 13

N
Nonrecourse debt, 3-5, 12, 14
  Nonrecourse/anti-deficiency states, 12-13

P
Potential timing differences, 5-6

R
Recourse debt, 3-6, 14
  Resources, 13

S
Short sale, 1-2, 12, 14

T
Tax attributes, 8-9
  Tax treatment
    Business property, 10
    Investment property, 11
    Principal residence, 9-10