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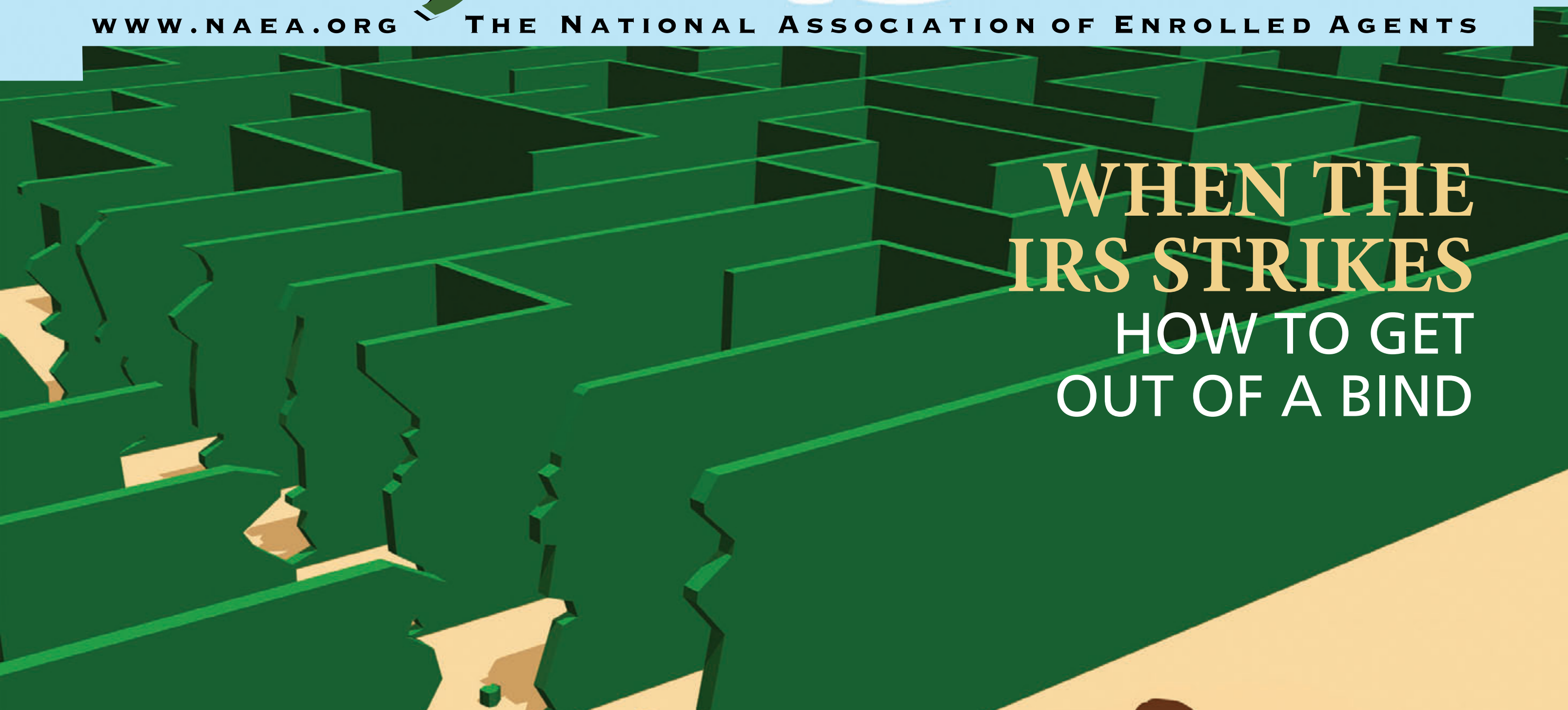

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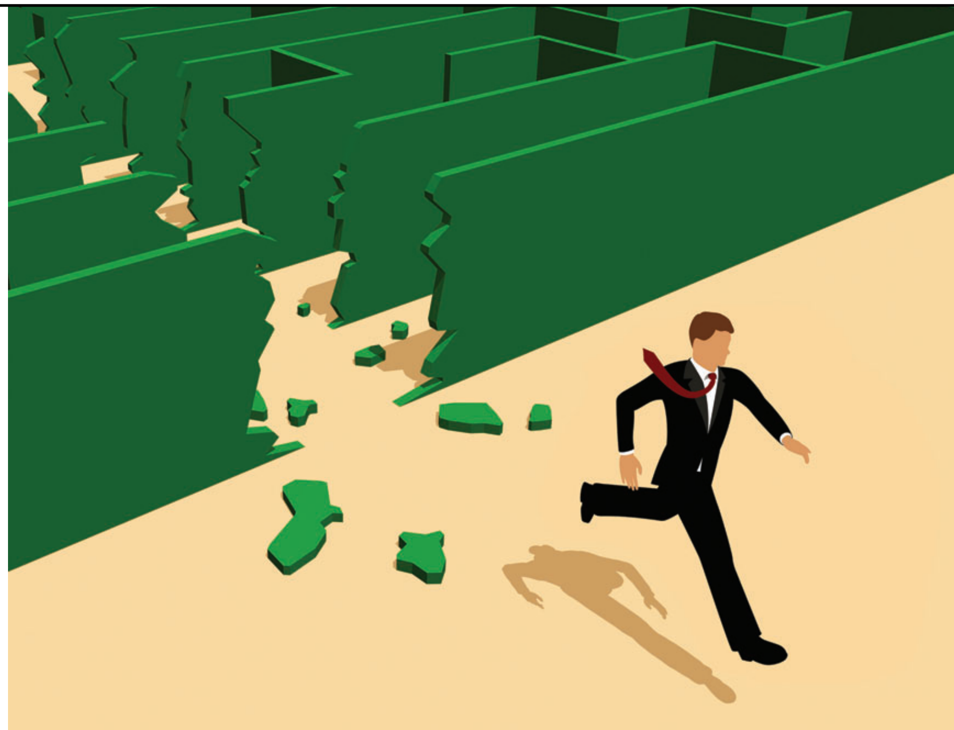

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Your Questions Answered

Compiled by Gil Charney, CPA

QUESTIONS ABOUT CANCELLATION OF DEBT, abandonment of property, foreclosure, repossession, bankruptcy, and insolvency have increased dramatically in the last few years, reflecting the economy in general and the real estate market in particular. Below are a few of the many questions EAs have submitted on reporting foreclosures on rental property.

REPORTING A FORECLOSURE ON RENTAL PROPERTY

Q: Taxpayer purchased a rental home in 2001 for $210,000 and refinanced it in 2006 after making some improvements. The lender foreclosed on the rental property in 2010. Taxpayer received Form 1099-A showing $174,700 in box 2 and $185,000 in box 4. How is a foreclosure on rental property reported? Is there any cancellation of debt income?

A: As with the foreclosure of a taxpayer's principal residence, a foreclosure on rental property involves the "sale" of the property back to the lender. If the lender also cancels all or a portion of the debt, there may be income from the cancellation of debt. Our response addresses each of these separately.

Sale of Property

A foreclosure is treated as a sale of the property back to the lender, with gain or loss to be recognized by the taxpayer. The gain or loss is the difference between the amount realized and the taxpayer's adjusted basis in the property.

The amount realized depends on whether the debt is recourse debt or nonrecourse debt. If the debt is recourse debt (the lender can claim assets of the debtor if the secured property does not fully satisfy the outstanding debt), then the amount realized is the smaller of: (1) the outstanding debt immediately before the foreclosure (in this case, $174,700), reduced by any amount of recourse debt for which the taxpayer was liable, and (2) the FMV of the property ($185,000). Here the smaller of two is $174,700, and is used as the amount realized for calculating any gain or loss on the "sale" of the property to the lender.

If the debt was nonrecourse debt (the property was fully secured by the mortgage and the lender cannot go after any other assets that the taxpayer may own), then the amount realized is the amount of the outstanding debt (in this case, $174,700).

Once the amount realized has been determined ($174,700 regardless of whether the debt was recourse or not in this case), the figure must be compared to the taxpayer's adjusted basis in the rental property. See IRS Pub. 551 (Basis of Assets) for information on how the taxpayer's basis in the property might have been increased or decreased during ownership. Note that any Sec. 1245 property in the rental unit may be subject to depreciation recapture (and taxed as ordinary income); there would be no depreciation recapture on the rental home itself (Sec. 1250 recapture) if it was depreciated under the straight-line method. A loss on the sale of the property results in an ordinary loss (not a capital loss).

The sale of the rental property must be reported on Form 4797 (Sales of Business Property). Report the sale of the building in Part III of Form 4797 if sold at a gain and in Part I if sold at a loss. A loss on the sale is a Sec. 1231 ordinary loss, not a capital loss. Report the sale of the land separately in Part I, whether sold at a gain or loss. The unrecaptured Sec. 1250 gain is entered in Part III of Schedule D Form 1040 (Capital Gains and Losses).

Cancellation of Debt

Form 1099-A (Acquisition or Abandonment of Secured Property) reports that the lender has repossessed or foreclosed on the property. Form 1099-C (Cancellation of Debt), not Form 1099-A, is used to report any cancellation of debt.

Form 1099-A box 2 is the amount of the outstanding mortgage debt, and box 4 is the FMV of the property. As noted above, Form 1099-A is not used to report cancellation of debt. However, if the value of the foreclosed property (box 4) exceeds the amount of outstanding debt (box 2), as in this taxpayer's case, the debt is considered fully satisfied because the value of the property exceeds the outstanding debt. There is no longer any debt to cancel after the lender acquires the property (which may explain why the taxpayer did not receive a Form 1099-C).

CANCELLATION OF DEBT ON RENTAL PROPERTY SHORT SALE PROPERTY

Q: My client has two rental homes which will be sold short. For both properties combined, the cost is $300,000, accumulated depreciation is $45,000, and outstanding mortgages (recourse) total $220,000. The fair market value (FMV) of both properties combined is $145,000. We have completed an insolvency worksheet (IRS Pub. 4681, p. 6) and determined that the client is insolvent by $258,000.Because the client is insolvent by more than the debt cancelled, does the cancelled debt get reported on Form 982 as a nontaxable item? Or what is taxable on the debt relief?

A: When a rental home secured by a recourse loan is sold short, the taxpayer will incur a loss on the disposition of the rental properties. He will need to report a sale as well as any income from the cancellation of debt (COD) or its exclusion. The COD income is excluded from gross income to the extent your client is insolvent. Therefore, because your client's insolvency exceeds the debt cancelled, none of the COD income is included in gross income. Instead, Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)) is used to reduce certain tax attributes (but not below zero).

Sale

The short sale or foreclosure of each rental is reported as if it were a regular sale. The amount realized upon the disposition is compared with the taxpayer's adjusted basis. For recourse loans, the amount realized on the foreclosure or repossession is the *smaller* of (1) the outstanding debt immediately before the transfer (and reduced by any amount for which the taxpayer remains personally liable immediately after the transfer), or (2) the FMV of the transferred property. Here, the FMV of the property ($145,000) is less than the amount of debt cancelled ($220,000), so the amount realized is $145,000. The amount realized is then compared with your client's adjusted basis of $255,000 (cost of $300,000 less depreciation of $45,000). This difference is reported as a loss of $110,000 from the sale of a rental property (sale price of $145,000 less adjusted basis of $255,000).

Note: *We are using your numbers for illustration only. The actual amounts to be reported on your client's tax return may vary. For example, there may be other basis adjustments on your client's property besides depreciation that you have not mentioned.*

The sale of the property at a loss is reported on Form 4797 (Sales of Business Property) Part I. A loss on the sale is a Sec. 1231 ordinary loss, not a capital loss. The building and the land are reported separately in Part I. In many cases, the real estate contract will not allocate the sales price between the land and building. The taxpayer's property tax bill, however, should show the value the tax assessor assigned to the land and the value assigned to the improvements. These values can be used to allocate the purchase price between the land and the building.

Also, your client may be able to deduct any suspended passive activity losses on line 23 of Schedule E Form 1040 (Supplemental Income and Loss) if the properties were sold in a fully taxable transaction to an unrelated party.

Cancellation of Debt Income

The COD income is taxable in the year it is received (IRC Sec. 61(a)(12)) unless an exclusion applies. You are correct that if an exclusion applies (such as insolvency), COD income is not included in gross income.

Even though there is no taxable COD income, you must complete Form 982 to report the excluded income. The form lists several reasons, including insolvency for excluding income from debt cancellation. Insolvency is determined as the extent to which a taxpayer's liabilities exceed his assets (at FMV) immediately before the cancellation of debt. For example, if the debt was cancelled on October 1, 2010, then the taxpayer would determine his insolvency as of 11:59 pm on September 30, 2010.

Also, please note that if a taxpayer has multiple cancellations of debt during the year, insolvency must be determined immediately before each cancellation to determine whether the exclusion applies to each cancellation. The reason is that the extent of a taxpayer's insolvency may vary between the cancellation of one debt and the next.

A worksheet for determining insolvency is available in IRS Pub. 4681, p. 6 (Canceled Debts, Foreclosures, Repossessions, and Abandonments). Even though this insolvency worksheet need not be attached to the tax return, it may be helpful to do so. Your client should retain it as part of his records.

Because the taxpayer can meet the insolvency exclusion for the debt cancelled, the taxpayer will need to complete Form 982 and attach it to the Form 1040 to exclude the cancelled debt from gross income. Form 982 line 1b is used to report that the COD income to be excluded is due to insolvency. Only one Form 982 is required (showing the total of COD income excluded), even if more than one debt is excluded during the year.

The amount of cancelled debt excluded from gross income reduces tax attributes (but not below zero), the reduction of which is determined on Form 982 Part II. A statement identifying any property for which basis is reduced also must be attached. See IRS Pub. 4681, p. 8 to determine the order of tax attributes that must be reduced.

Finally, if a taxpayer could not qualify for any COD income exclusion, the cancelled debt that is included in gross income must be reported on Form 1040 Schedule E, line 3 ("Rents"). A "Statement of Facts" should be included that explains that the total "Rents" line reported includes both regular rental income and COD Income.

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Gil Charney, CPA, CFP®, MBA, is a principal tax analyst at The Tax Institute at H&R Block, where he conducts research into complex tax problems and analyzes tax legislation. He also leads a team of EAs, CPAs, and tax attorneys in maintaining The Tax Institute's Tax Research Center. He has extensive experience in consulting, research, and corporate financial management. He also has taught graduate-level courses in accounting and finance and directed H&R Block's tax training department.

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About the Author: See p. 17 of Jan/Feb '11 EAJ.

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