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## Tax Consequences of “Short Sales”, Foreclosures, and Loan Modifications

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A reduction, modification or cancellation of indebtedness can have significant consequences under federal tax law. Too often, however, debtors fail to take tax considerations into account when they restructure debt, especially when navigating their way through the process without legal counsel.

The tax rule that applies to cancellation of debt is fairly straightforward. Under section 61(a)(12) of the Internal Revenue Code, as amended, cancelled debt – COD – income generally is taxed as ordinary income. There are several statutory exceptions to this rule. But debtors may pay a price for those exceptions in the form of reductions in debtor “tax attributes” such as basis of assets and certain tax credits.

### Foreclosures and Repossessions

Most debt workouts, however, don’t involve simple cancellation of debt. A creditor may agree to accept a voluntary conveyance of the loan collateral in complete satisfaction of the debt – for example, a house in the case of a mortgage – or the creditor can foreclose on, or repossess, the collateral.

Either of these actions, in effect, amounts to a sale of the property, so the debtor will have some mix of cancellation of debt income and capital gain under IRC section 1001. The mix of COD income and sale or exchange gain depends on whether the debt is recourse or nonrecourse.

In the case of a recourse debt – which allows the creditor to recover other debtor assets in addition to the original collateral – the conveyance of, or foreclosure on, the collateral is split between COD income and capital gain.

First, the transaction results in a capital gain or loss, which depends on the difference between the fair market value of the property and the debtor’s adjusted basis. If the fair market value of the property exceeds the amount of the debt, there is no COD income. If, however, the fair market value is less than the debt, then the debtor may realize COD income in the amount that the canceled debt which exceeds the fair market value – in addition to any capital gain or loss. The debtor can avoid COD income if the creditor accepts a deficiency note to cover any shortfall between the value of the property conveyed and the amount of the debt.

If there is an auction or foreclosure proceeding, the bid price is presumed to equal the fair market value of the property in the absence of clear and convincing evidence to the contrary. But a debtor should be wary of this presumption if a distressed sale yields very little, and should be prepared to rebut the presumption with an appraisal.

In the case of a nonrecourse debt – which bars a creditor from attaching assets of a debtor beyond the original collateral – cancellation of debt income is removed from the tax equation.

A voluntary conveyance or foreclosure of property in satisfaction of a nonrecourse debt is treated as a sale or exchange of the transferred property. The debtor simply realizes a capital gain or loss equal to the difference between the principal amount of the debt and the adjusted basis of the property.

### Exclusions

COD income may be excluded from gross income if the debtor falls within certain exceptions enumerated in IRC § 108. Significant exclusions include bankruptcy, insolvency, and mortgage forgiveness debt relief.

COD income is not recognized for tax purposes if the discharge of the debt occurs in a federal bankruptcy proceeding pursuant to a plan approved by the court – whether under Chapter 7, 11 or 13. Under the bankruptcy exclusion, there is no limit on the amount of COD income that may be excluded.

The insolvency exclusion, however, applies only when, and to the extent, a debtor's liabilities exceed the fair market value of assets, and income may only be excluded to the extent of the insolvency. Assets exempt from the claims of creditors must be counted in determining whether the debtor qualifies for the insolvency exclusion. This could be a factor as to whether the debtor seeks to use the insolvency exclusion or, instead, restructure in a formal bankruptcy proceeding.

The last significant exclusion is for mortgage forgiveness. Under the Mortgage Forgiveness Debt Relief Act of 2007, this exclusion applies only to the discharge of this kind of debt if it occurs on or after January 1, 2006, and before January 1, 2013. The indebtedness must be incurred to acquire, construct or substantially improve any qualified principal residence, and be secured by that property. The exclusion is limited to \$2 million of COD income for a married couple filing jointly (\$1 million for single filers and married persons filing separately), and it must be used to reduce the basis of the principal residence.

If the indebtedness exceeds the monetary limits, or if a portion is used for a nonqualified purpose, those portions of the indebtedness will be deemed to have been canceled first and must therefore be treated as COD income.

### Attribute Reduction

As mentioned earlier, the price for excluding COD income is that certain specified tax attributes of the debtor then must be reduced. When COD income is excluded by a debtor in conjunction with bankruptcy or insolvency, the debtor's tax attributes must be reduced in the following order: (1) net

operating losses; (2) general business credits; (3) alternative minimum tax credits; (4) capital loss carryovers; (5) basis of assets; (6) passive activity loss and credit carryovers; and (7) foreign tax credit carryovers. The credits are reduced at the rate of 33⅓ cents for each dollar of excluded COD income. The other attributes are reduced on a dollar-for-dollar basis.

The reduction in attributes is made after the determination of taxes for the taxable year of the debt discharge. That means attributes arising in or carried to the year of the discharge may be used to reduce income or tax for the year of the discharge, and the remaining attributes themselves are reduced for the following year.

Flexibility in the rules for reducing attributes allow a debtor, with careful planning, to apply the rules to best advantage. Instead of reducing attributes in the order prescribed above, the debtor may elect, pursuant to IRC section 1017, to first reduce the basis of its depreciable property. In that way, the debtor may choose to preserve net operating losses for future years.

The exclusions from COD income for qualified principal residence debt specifically provide for a reduction in the basis of the property securing the debt instead of following the ordering rules for attribute reductions.

### Modification of Debt

A creditor may agree to modify the terms of a loan or other debt, usually by reducing the interest rate or extending the maturity date. The tax consequences of such a modification depend on whether it is defined as "significant" under Treasury regulation section 1.1001-3.

Generally, a modification is significant only if, based on all the facts and circumstances, the legal rights or obligations are altered in an economic manner and to a degree that changes the character of the debt in a major way.

A modification that changes the timing of payments, for instance, is significant if it results in the "material" deferral of scheduled payments. A deferral will be material if it extends a payment period more than five years, or more than half of the original term of the loan, whichever is less. Other significant modifications in a debt may include

changes in its yield to the creditor; the substitution of a new obligor replacing the original debtor on a recourse debt; a change in the collateral or guarantee on a nonrecourse debt; or changing the debt instrument from recourse to nonrecourse, or vice versa.

If a debt modification is not significant under the definition of the Treasury regulations, or if it was contemplated or provided for in the original debt instrument, then it generally has no tax consequences.

If the modification is significant, however, the debt is deemed to be exchanged for new debt in a taxable exchange under IRC section 1001. In that case, the debtor will generally be treated as having satisfied the old debt with an amount of money equal to the issue price of the new debt.

Earle Law Offices provides trial and appellate litigation, as well as non-litigation, legal services in the areas of business law, constitutional and civil rights law, family law, real estate law, tax law, and trusts and estates.

\* Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Fourth and Ninth Circuits, federal trial courts in the Northern District of California, and the United States Tax Court. He has served as a Judge Pro Tempore for the Santa Clara Superior Court, and is also a licensed Real Estate Broker.

Mr. Earle received his law degree from the Santa Clara University School of Law, where he served as an Editor of the school's Law Review, and where he received awards for academic excellence. He received his undergraduate degree, with honors, in business administration from the University of La Verne.

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