

## **Lost Your Property In Foreclosure? The Big Gorilla (IRS) May Be Looking For You !**

The fixed market value of real estate has generally fallen in recent months. In many instances that value may even be below the outstanding principal balance of a loan obtained to purchase or refinance the real estate. With upward adjustments in interest rates, rising insurance premiums and property taxes, and ever increasing government budgets; the sale or disposition (including lender foreclosure) of the real estate solves the problem. Well, not exactly.

A lender foreclosure is considered a sale or exchange of real property. The real estate owner may be required, under the Internal Revenue Code, to recognize a gain or a loss on account of the foreclosure. This may also happen if the lender and the real estate owner agree that the real estate will be voluntarily conveyed to the lender, eliminating the actual formal legal process, i.e. the foreclosure itself.

In most cases and especially in connection with residential real estate, a borrower typically is personally liable for full repayment of the debt obligation. This is commonly known as a "recourse debt." A mortgage only documents that certain real property, in addition to the borrower's good name and credit, secures repayment for the loan. The following discussion only addresses recourse debt situations.

If real estate is foreclosed upon (or if a deed is voluntarily given to the lender) and the debt is recourse debt, generally the debtor is required to report ordinary income equal to the outstanding debt principal in excess of the fair market value of the real estate transferred to the lender. This cancellation of indebtedness income is separate from gain or loss on the foreclosure or transfer itself. If the recourse debt is \$1,000,000.00 but the real estate is worth only \$800,000.00 when real estate "transferred" to a lender, the Internal Revenue Service says there is \$200,000.00 of income. Essentially, the borrower received \$1,000,000.00, but only gave up \$800,000.00 in return for satisfaction of the debt. Generally this is ordinary income.

Note that sometimes an owner finds a purchaser for the real estate. What if present market value is \$800,000.00, and the owner arranges with his or her mortgage lender to accept the \$800,000.00 as full payment of a \$1,000,000.00 debt? This is sometimes called a "short pay" satisfaction. The same rule applies and there is \$200,000.00 of income realized.

The above illustration does not cover actual gain or loss on the foreclosure or transfer itself. If the tax basis of the real estate is \$1,000,000.00, but fair market value is only \$800,000.00, there is a \$200,000.00 loss on the foreclosure. This loss may not be a deductible loss, or it may be a capital loss subject to separate rules under the Internal Revenue Code. It could take years to receive tax benefit from a significant capital loss. The rules are often difficult to understand or apply to real world situations and can lead to surprising unanticipated results. Using either Form 1099-A or Form 1099-C, the lender is required to report foreclosure; and if above \$600.00, all debt cancellation income to the Internal Revenue Services. However, the failure of a lender to send a 1099 does not relieve the tax payer of his or her reporting obligation.

Debt cancellation income is subject to several exemptions. Bankruptcy is an exception. Another important exemption is if the borrower is insolvent both before and after the foreclosure or

transaction. It is important to accumulate this information at the time of the foreclosure or transfer. Due to loss of access to or future unavailability of information, it may not be possible to show insolvency, if a substantial period of time has elapsed. Also, the above basic illustrations indicate that fair market value is important. The real estate owner should have evidence of fair market values of the real estate at the time of the foreclosure or voluntary return of property. Appraisals or even agreement with the borrower's lender could be obtained. Sale by the lender soon after the foreclosure transaction may (but often is not) authoritative evidence of fair market value at the time of the foreclosure or transfer to the lender.

If you are faced with this type of situation, you should contact professionals knowledgeable in both real estate and tax laws. The following formulas should permit your initial review of possible cancellation of debt or foreclosure gain or loss consequences:

- 1. Debt amount canceled upon property transfer \_\_\_\_\_
- 2. Less real estate fair market value [\_\_\_\_\_]
- 3. Cancellation of debt income \_\_\_\_\_

OR

- 1. Smaller of amount of debt canceled upon property transfer or real estate fair market value \_\_\_\_\_
- 2. Add foreclosure sale proceeds received \_\_\_\_\_
- 3. Total \_\_\_\_\_
- 4. Less tax basis of transferred property [\_\_\_\_\_]
- 5. Foreclosure or repossession gain or loss \_\_\_\_\_

Failure to report this kind of income can have future adverse results. For example, upon any audit, penalty and interest in addition to income tax generally will be assessed. Additionally, if the omitted income is a sufficient percent of total income, the general three (3) year statute of limitations may be extended to six (6) years.

Please call one of our attorneys for further information.

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