FORECLOSURES GENERATE TAXABLE INCOME

by

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Throughout much of the 1980s, the value of Southern California real estate skyrocketed in a manner that allowed many to refinance their existing properties in order to use the loan proceeds to acquire other properties. Unfortunately, in the 1990s the economic climate has been such that many have not been able to satisfy their financial obligations in a timely manner resulting in increased mortgage delinquencies. Many of these delinquent obligations have been settled or some other form of agreement has been reached with the underlying financial institution resulting in significant potential tax consequences for the borrowers.

A 1931 Supreme Court decision established the principle that the gain or savings realized by a borrower upon the reduction or cancellation of their outstanding indebtedness for less than the amount due may become "income" to the borrower for tax purposes. The general rule is that cancellation of debt creates income to the borrower in the year canceled in an amount equivalent to the difference between the amount due on the obligation (the face amount) and the amount paid for its discharge or satisfaction.

As a result of a significant increase in the number of failed savings and loan associations during the 1980s the Resolution Trust Corporation (RTC) was created by Congress in 1989 to administer the disposition of the failed institution's assets and liabilities. The RTC has liquidated billions of dollars of loans secured by real estate. Many of the loans were settled for less than full value. For example, an S&L may have made a $15 million loan secured by real estate and finds that the real estate securing the loan is now only worth $5 million. The RTC and the borrower may agree to settle the loan based on the lower value resulting in a cancellation of indebtedness to the borrower of $10 million which may result in up to $10 million of taxable income to the borrower. Upon the conclusion of a loan settlement, the financial institution or the RTC is required to file a Form 1099A advising both the borrower and the IRS of the actual amount of the loan forgiven.

A borrower may realize income by the payment or purchase of obligations at less than face value. A debt may be deemed discharged when:

1) The borrower or a party related to the borrower acquires the debt for less than its face amount,

2) The lender and the borrower agree to settle the debt for less than the full amount due,

3) The lender simply cancels or discharges the total debt,

4) The debt is discharged by a bankruptcy court following the filing of a bankruptcy petition by or on behalf of the borrower (however, a bankruptcy debtor can exclude cancellation of indebtedness income from its gross income and reduce its other tax attributes),

5) The statute of limitations within which the lender must commence an action to recover the debt expires,

6) The borrower abandons the property, or

7) The lender obtains title through a foreclosure. For tax purposes, a foreclosure - a proceeding that bars or extinguishes the borrower's ownership interest in a mortgaged asset - is treated as a sale or exchange of the secured asset.

Cancellation of debt (COD) arising out of a recourse obligation generally results in ordinary income. A recourse obligation is debt for which the borrower may become personally liable. Conversely, a non-recourse obligation is debt for which the borrower may not be personally liable (the lender may generally only seek recovery from the asset securing the loan). A partnership obligation will be treated as recourse to the extent one or more partners bears the economic risk of loss with respect to the obligation.

If recourse debt is satisfied by the transfer of an asset to the lender at a price equal to or less than the fair market value of the asset, there will be no COD income but the borrower will have reportable gain from the sale or exchange of the asset to the extent the fair market value of the asset exceeds the borrower's tax basis in the asset. To the extent the recourse debt satisfied by a transfer of the asset to the lender is greater than the fair market value of the asset, the borrower will have COD income based on the difference between the amount of the debt and the fair market value of the asset. As such, it is possible to have both ordinary COD income and gain from the sale or exchange of an asset (capital gain) arising out of the settlement of a recourse obligation.

Full satisfaction of a non-recourse obligation will be treated as a sale of the asset for the amount of the obligation. Gain associated with the settlement of a non-recourse obligation is recognized without regard to the fair market value of the asset. If the borrower has gain on the foreclosure of depreciable property, the depreciation previously allowable may have to be recaptured as ordinary income.

If the debt cancellation occurs in a Title 11 bankruptcy proceeding of the borrower there will be an exclusion of the COD from gross income regardless of whether the bankruptcy is filed under Chapter 7, Chapter 11, or Chapter 13,. For this bankruptcy exclusion to apply, the discharge or cancellation must be granted by the bankruptcy court or pursuant to a plan approved by the bankruptcy court.

Similarly, if the discharge occurs when the borrower is insolvent, there will be an exclusion of the COD income from gross income. For the insolvency exception to apply, the amount of excluded COD income cannot exceed the extent to which the borrower is solvent. For this purpose, insolvency is the amount by which the borrower's liabilities exceed the fair market value of the borrower's assets immediately before the discharge. A borrower that is made solvent by the debt cancellation recognizes income to the extent of their solvency arising out of the cancellation (i.e. to the extent the value of the borrower's assets exceeds the borrower's liabilities immediately after the cancellation). If the borrower remains insolvent after the debt cancellation, all of the COD is excludable from income.

In the case of partnerships, insolvency is determined at the partner level on a partner by partner basis. Despite the insolvency exception, an insolvent partner may still be required to recognize gain when partnership debt is cancelled, since the reduction of a partners share of liabilities is treated as a distribution to the partners. If a deemed distribution exceeds a partners tax basis in the partnership, the partner may have to recognize taxable gain. This gain is taxable regardless of the partners insolvency. In the case of an S Corporation, insolvency is determined at the corporate level.

The foregoing COD exclusions are ordered so that a bankruptcy related discharge takes precedence over an insolvency discharge. In this regard, if the borrower is the debtor in a bankruptcy proceeding it is not necessary to determine if the borrower is insolvent. However, borrowers who exclude COD from gross income are required to reduce certain other tax attributes, including net operating losses and net operating loss carryovers, general business credits, minimum tax credits, capital loss carryovers, the tax basis of their depreciable and non-depreciable assets, passive activity loss and credit carryovers, and other tax credit carryovers. Although California tax law generally incorporates each of the foregoing provisions of federal tax law regarding COD, there are certain modifications to the list of tax attributes that must be reduced under California tax law.

These provisions are designed to defer, but eventually collect within a reasonable period, tax on ordinary income attributable to the cancellation of the indebtedness. As a result, it is extremely important for a borrower to consider the various tax consequences associated with the settlement or cancellation of any debt before entering into an agreement with the underlying lender.