CLOSE ENCOUNTERS OF THE WORST KIND:
TAX AND OTHER ISSUES RELATED TO DISTRESSED PROPERTIES IN THE NEW MILLENNIUM

CAL CPA REAL ESTATE CONFERENCE

June 18, 2008

Cameron L. Hess
Wagner Kirkman Blaine
Klomparens & Youmans LLP
10640 Mather Blvd., Suite 200
Mather, CA 95655
Telephone: (916) 920-5286
chess@wkblaw.com

Douglas L. Youmans
Wagner Kirkman Blaine
Klomparens & Youmans LLP
10640 Mather Blvd., Suite 200
Mather, CA 95655
Telephone: (916) 920-5286
dyoumans@wkblaw.com

DOUGLAS L. YOUMANS

Dyoumans@wkblaw.com
Wagner Kirkman Blaine Klomparens & Youmans LLP
10640 Mather Boulevard, Suite 200
Mather, CA 95655

EDUCATION: Temple University, B.A. (Magna Cum Laude); 1977; Golden Gate University, M.B.A., 1984; McGeorge School of Law, University of the Pacific, J.D., 1980

ACADEMIC ACTIVITIES:

Lecturer: 1982 to present for various professional societies and organizations, including Continuing Education of the Bar, Northern California Tax Conference, Sacramento Board of Realtors, Society of California Accountants ("SCA"), Society of Enrolled Agents, California Society of CPAs ("CALCPA"), International Association of Financial Planners, Gold Country Estate Planning Council, Sacramento Estate Planning Council, Sacramento CPA Law Forum, Internal Revenue Service, Sacramento County Bar Tax Section, Sacramento County Bar Real Estate Section, State Bar, State Bar Tax Section, (Lonnie McGee's) Annual Tax & Estate Planning Forum.

Adjunct Professor: Golden Gate University, 1985 to 2004: Business Law; Tax Research; Estate and Gift Taxation; Estate Planning; Federal Tax Procedures; Tax Aspects of Marital Dissolution; Tax Accounting Periods and Methods; Tax Characterization of Income and Expenses; California State University at Sacramento, 1984-1985: Introduction to Accounting; Managerial Accounting.

AFFILIATIONS: Sacramento County Bar Association; American Bar Association; State Bar of California; State Bar of California Practice Management, Trusts and Estates and Tax Sections; Corporate and Business Entities Committee of the Tax Section of the State Bar of California; Executive Committee of the Tax Section of the State Bar of California; author and paper presenter for several of the California State Bar's delegations to Washington D.C.; Society of California Accountants (SCA); California Society of CPAs (CALCPA); American Institute of CPAs (AICPA); Franchise Tax Board Advisory Group.

ADMISSIONS: California State Bar, 1980; Certified Specialist, Taxation Law, 1988; U.S. Tax Court, 1983; U.S. District Court, Eastern District of California, 1982; U.S. Court of Appeals, 7th Circuit, 1987; Licensed as a CPA by the State Board of Accountancy, 1983

- **REPRESENTATIVE PUBLICATIONS AND PRESENTATIONS:**

- Advanced Estate Planning
- Family Entities
- Generation Skipping Transfer Taxes
- Circular 230
- Estate Planning for Small Businesses
- Single Member LLCs—Estate and Gift Tax Treatment
- How to Draft Wills and Other Estate Planning Documents
- Nuts and Bolts of Corporate Dissolutions
- Retirement Plan Distributions
- Tax Aspects of Bankruptcy
- Tax Consequences of Partnership Dissolutions
- Estate Planning for Family Business Owners
- Domestic Partnerships
- Beyond Section 2036; Dealing with Family Entities
- Income, Fiduciary and Other Taxes and Issues Dealing with Family Entities
- Tax Deferred Exchanges
- Tax Issues in Personal Injury Claims
- Tax Planning for Real Estate Dispositions and Exchanges
- Taxation of Capital Assets
- Using California Trusts: Planning, Implementing, Administering and Terminating
- Choice of Entity
- Tax Updates
- Nuts and Bolts of S Corporations
- Asset Protection
- Tax Aspects of Co-Ownership of Property
- Tax Patents
- ULPA 2008
- Repeal of the State Death Tax Credit
- Single Member LLCs and the Effect of the Check the Box Regulations for Estate and Gift Tax Purposes

CAMERON L. HESS
WAGNER, KIRKMAN, BLAINE
KLOMPARENS & YOUMANS LLP
J.D., M.B.T., C.P.A.

INTRODUCTION

Cameron L. Hess, Esq., C.P.A., is a Senior Principal with Wagner, Kirkman, Blaine, Klomparens & Youmans LLP. His practice covers tax and business planning and tax controversy representation. Mr. Hess has over 20 years' experience in representing a diversity of organizations and industries.

AREAS OF PRACTICE

FEDERAL AND STATE TAXATION

Mr. Hess assists in all areas of client representation for federal and state tax planning and advocacy. Mr. Hess has a diverse background, which includes, among other cases, complex tax cases involving record reconstruction, trust fund penalty (for nonprofit officers); unrelated business income tax (nonprofit), corporate reporting, amnesty/penalty waiver and state tax (franchise, property, employment and sales tax.) Mr. Hess also actively handles tax appeals and collection actions. For business clients, Mr. Hess is active in tax issues affecting pass-through and corporate entities, emphasizing closely-held business entities. In the area of state and local taxation, Mr. Hess has appeared before the FTB hearings concerning proposed regulations/actions. Mr. Hess was previously a tax manager with KPMG Peat Marwick, where his practice involved compliance, planning and tax controversy representation for local, national and multinational clients.

REAL ESTATE

Mr. Hess represents clients on real estate acquisition, development and syndication. Mr. Hess clients include real estate builders, investors and managers, wherein a substantial portion of his practice is in the real estate industry. Mr. Hess handled the largest 1998 Sacramento area real estate sales transaction.

BUSINESS LAW

Mr. Hess advises closely held businesses with respect organization, business transactions, sales and mergers for corporate and pass-through entities. Industry areas include construction and medical.

ESTATE PLANNING

Mr. Hess represents clients in extensive areas of complex estate planning, including insurance and charitable trusts and business succession planning. Mr. Hess's approach integrates business, tax and estate planning aspects of advising closely held businesses.

NONPROFIT LAW/PLANNED GIVING

Mr. Hess is the Nonprofit Practice Director for the firm and advises firm nonprofit clients with respect to business and organizational concerns relevant to nonprofit organizations, including organizational structure, government agency relations, affiliations, financial and tax accountability, planned gifting and business agreements. Mr. Hess has represented clients with respect to a number of legal issues including tax examinations and state Registry of Charitable Trusts. Mr. Hess advises nonprofits within and outside of California. Representative clients include: America Against Graffiti, Take the Lead, California International Baccalaureate Organization, Diversity in Law Foundation, California State Fair Memorial

Foundation and Wind Youth Services. Mr. Hess has actively assisted for ten years as an instructor with the Nonprofit Resource Center on multiple topics covering the spectrum of nonprofit organizations.

EDUCATION

University of California, Berkeley (B.S. (Accounting), 1980); University of Southern California (M.B.T., 1983); University of Southern California (J.D., 1983). Member: Tax Law Journal. Mortar Board, Honor Society, Beta Alpha Pi, Phi Alpha Delta (Law); Student Member of California Academic Senate.

ADMISSIONS

- Admitted to California State Bar, 1984
- Admitted to U.S. Court of Appeals, 9th Circuit, 1984
- Admitted to U.S. District Court, Eastern District of California, 1984
- Admitted to U.S. District Court, Central District of California, 1991
- Admitted to U.S. Tax Court, 1991
- Admitted as Certified Public Accountant, 1988

AFFILIATIONS

CalCPA Sacramento Chapter (Director – 1994 to 2005, Past President, Legislative Liaison to Cal CPA Financial Planning Committee – to 2002, Chair of Real Estate Committee; member Nonprofit Committee; Estate & Financial Planning Committee); Society of California Accountants (Director); California Society of Enrolled Agents; Sacramento County Bar Association (Tax Section); State Bar of California (Tax Section); American Bar Association; Past Member: California Manufacturers Association (Corporate Counsel Steering Committee, 1992-1994); Sacramento Metropolitan Chamber of Commerce, State Bar Partnerships and Limited Liability Companies Committee (1995-1997); Director of Easter Seals.

ACADEMIC ACTIVITIES

Published: Published in CCH Taxes; Spidells California Taxletter; The Tax Executive; Los Angeles Lawyer.

Instructor: U.C. Davis CFP Program (Taxation); CalCPA Education Foundation; Lorman Education Services; National Business Institute; Nonprofit Resource Center (Updating Bylaws and Organizations, Fundraising in light of UBIT, Nonprofits-For-profit Subsidiaries, Nonprofit Development Conferences – Rural Assistance Associations& State Park Associations.)

TABLE OF CONTENTS

I. Introduction. 1

A. Bank/Institutional Perception. 1

II. Cancellation of Indebtedness Issues. 2

A. General Rules. 2
B. Debtor's Tax Consequences. 12
C. Impact on Lender. 14
D. Exception: Seller Reacquisitions Under IRC Section 1038. 15
E. Partnerships and CODI. 17
F. S Corporations. 24

III. Mortgage Forgiveness Debt Relief Act of 2007. 24

A. Temporary" Relief for Discharge of "Qualifying Indebtedness." 24

IV. Summary/Recap of the Tax Rules Relative to Dealing with Distressed Properties and CODI. 25

A. 3 Basic Rules to Know. 25
B. Two Supreme Court Cases You Should Know. 26
C. Nonrecourse/Recourse Debt. 26
D. Quick Guide—Personal Residences. 26

V. Recent Developments. 29

A. *Gilbert Hahn, Jr. and Margot H. Hahn v. Commissioner* 29
B. *Great Plains Gasification Associates v. Commissioner* 29
C. *Patrick G. & Valerie V. O'Malley v. Commissioner* 30
D. *Johnson v. Commissioner* 30
E. *Alpert v. US* 31
F. *In re: Higgins* 31
G. *Keith v. Comr.* 32
H. *Stevens v. Comr.* 32
I. *Quartemont v. Comr.* 32

CLOSE ENCOUNTERS OF THE WORST KIND: TAX AND OTHER ISSUES RELATED TO DISTRESSED PROPERTIES IN THE NEW MILLENNIUM

I. Introduction.

The California's real estate market is troubled by a number of factors including:

- Depressed residential and commercial real estate values;
- Stagnant growth in employment;
- Skittish buyers;
- Over-extended financing and speculation; and
- Billions of dollars worth of variable/interest only loans "resetting."

These factors have caused record numbers of defaults or near defaults on residential property financing. While apartments have done relatively well, the "cracks" in the market hit commercial properties in areas where there has been overexpansion. While economic forecasters are predicting the bottom of the market will hit the end of 2008, their prediction is that in sectors such as housing, "hitting the bottom" will not mean a recovery, and there will be a several additional years of absorption in overbuilt areas. If there is slump employment or the economy, these problems may pull the commercial market into a declining position and have some chance for affecting apartments. Unfortunately, the trend in California is for foreclosures to represent over 30% of the transfers in the market.

A. Bank/Institutional Perception.

Last year, banks, savings and loans, thrift associations and mortgage companies responded with a number of inconsistent responses with respect to the troubled residential real estate market. There are continuing problems, particularly due to the current complexity of how loans are handled wherein there are layers of "stripping" of value and conveyances of notes, wherein it is difficult to know who is the lender. Some institutions have packaged and sold off their loans and consequently there is little financial incentive for the bank to forestall foreclosure as its interest is limited to loan servicing.

On the other hand as to those mortgage institutions that have had to buy-back subprime loans, the implosion has meant that the institutions and bankruptcy trustees have begun to look to alternatives to foreclosure. Some institutions will negotiate a "workout." In a workout, the mortgage is restructured to accommodate the property owner. Sometimes, a

portion of unpaid interest is forgiven. Interest and payment terms are renegotiated. In other cases, the lender will agree to take less than full payment on the outstanding debt.

A growing trend is the recognition that lender losses are minimized where the property holder is allowed to sell the realty at a "market" price and some debt is forgiven, i.e., "short sale." Countrywide continues to offer more options even after the Bank of America takeover. Each of these options has different consequences to the borrower-taxpayer as well as to the lender.

This presentation is designed to explain some of the tax ramifications people holding "distressed" real estate might be facing in today's market, and to offer some "basic" strategies for assisting clients in this troubled real estate market.

II. Cancellation of Indebtedness Issues.

A. General Rules.

Generally, anytime there is a reduction in the principal amount of a mortgage caused by a compromise or negotiation not otherwise exempted or excluded (i.e., not involving a nonrecourse debt foreclosure, deed-in-lieu of foreclosure or abandonment) the debtor will have cancellation of indebtedness income ("CODI"), taxable as ordinary income. Typically, the amount of CODI will equal the amount of canceled principal, but it may include other amounts that are forgiven. CODI does not include forgiveness of unpaid interest to a cash method taxpayer wherein payment would result in a deduction.

CODI requires an actual forgiveness of debt. Generally, this occurs when it becomes clear that the debt will probably never be paid (*U.S. v. Kirby Lumber* (1931) 284 U.S. 1, 76 L.Ed. 131, 52 S.Ct. 4). CODI is not recognized by a debtor who does not accept forgiveness from his debts. (*Republic Supply Co. v. Comm.* (1976) 66 T.C. 446.)

1. CODI v. Sale. Whether CODI results is not always apparent. It depends on the type of transaction involved and the character of the loan as recourse or nonrecourse. Recourse means the creditor has personal recourse against the debtor (and his or her other assets) and not just the property securing the loan. Nonrecourse loans (e.g., in California, the original home purchase loan) are loans in which the lender's cannot go after the borrower personally but only the collateral securing the loan.

a. If recourse or nonrecourse debt is cancelled or reduced without the debtor's sale or forfeiture of the underlying property, CODI may result.

i. On a judicial (court) foreclosure, CODI may result if the lender voluntarily cancels the remaining loan balance due after a fair value hearing.

b. For a recourse debt cancelled due to a nonjudicial foreclosure, it is unclear if CODI will result. On the one hand, it would appear that the *Tufts* decision should be extended to recourse loans (and no CODI should result) if the bank waives the recourse nature of the loan by pursuing expedited foreclosure proceedings. On the other hand, in the one decision, a nonjudicial foreclosure on a recourse loan *Gehl v. Com'r* (1994) 102 TC 784, the IRS conceded that any debt exceeding the fair market value of property was CODI. Upon completion of the nonjudicial foreclosure, the *Gehl* court, therefore, did not have to determine whether CODI resulted. Instead, it simply ruled that, at the time of the nonjudicial foreclosure, the foreclosure would be treated as a sale and gain (or loss) from a sale or exchange.[1]

c. On the other hand, on <u>nonrecourse</u> debt, any type of a foreclosure sale or other disposition will generally cause the entire amount of the debt to be treated as the amount realized and the transaction will result in a capital gain or loss under IRC Sections 61(a)(3) and 1001. Absent a short sale, there is <u>no</u> CODI under IRC Section 61(a)(12), and IRC Section 108 does not apply.

2. <u>Release of Collateral</u>. The release of collateral securing an obligation does not, in and of itself, create CODI, although it may be considered a sale or exchange under the significant modification rules.

3. <u>Contested Liability</u>. The release of a contingent or contested liability generally does not result in CODI, on the theory that there was no indebtedness. For example, the release of a contingent liability to contribute capital to a partnership does not give rise to CODI. (*Hunt v. Comm.* (1990) 59 T.C.M. 635.) Likewise, the release of a guarantor of a loan usually does not result in CODI to the guarantor.

4. <u>CODI Avoidance</u>. For nonrecourse loans, no CODI arises from foreclosure, deed-in-lieu or abandonment. These are not exclusions from CODI, but sale/exchange transactions where the taxpayer must recognize gain to the extent the debt exceeds the taxpayer's basis, and IRC § 108(a) cannot be used to avoid that gain recognition.

---

[1] *Gehl v. Comm.* (1994) 102 T.C. 784. The court specifically stated: "Only the amount of the gain represented by the excess of such fair market value over basis is at issue, and we need not and do not resolve any issue of bifurcation in the context of recourse or nonrecourse indebtedness." *Id.* at 786.

5. Exceptions. There are a number of circumstances where CODI is treated as partly/wholly exempt/excluded or an adjustment to basis. These exemptions/exclusions do not apply to gain or loss from a deemed sale or exchange transaction.

a. IRC Section 108 Attribute Reduction. Perhaps the most significant exception to the current recognition of CODI income is IRC Section 108. IRC Section 108 provides that, in circumstances where a taxpayer is (i) bankrupt; (ii) insolvent; or (iii) realizes income from the cancellation of certain farm indebtedness; or (iv) realizes income from the cancellation of certain qualified real property business indebtedness ("QRPBI"), a taxpayer must elect to reduce specific tax attributes rather than include CODI in income.

b. Bankruptcy. An exclusion under IRC Section 108 (which also causes attribute reduction) is available/applicable when the debt is discharged in a Title 11 bankruptcy proceeding.[2] (IRC Section 108(a)(1)(A).)

With respect to troubled real estate, the existence of CODI arising from bankruptcy means generally a business or investment recourse loan that is secured by real estate. While IRC Section 108(a)(1)(A) may offer relief, a lot can go wrong. In particular, in a Chapter 7 (liquidation of assets) or Chapter 11 (Reorg) proceeding, the trustee may abandon over-encumbered real property back to the debtor if there is little recovery or the trustee wishes to avoid taxes on gain recognition which exceeds the amount of the recovery. In that event, IRC Section 108(a)(1)(A) may be entirely unavailable.

With home loans, bankruptcy is usually not done solely for CODI avoidance. First, purchase money loans involving personal residences in California are nonrecourse and therefore CODI may not be an issue. Second, the consideration of bankruptcy does not come within the context of CODI, but in deciding whether a bankruptcy should be a strategy to try to (i) retain the home under a Chapter 13 bankruptcy proceeding or (ii) delay the foreclosure process.

i. Planning Pointer. Generally, the taxable year of the debtor is determined without regard to the Title 11 case. However, the debtor may elect to treat his taxable year as two separate taxable years, the first of which ends on the day before

[2] Title 11 bankruptcy proceedings involve all types of bankruptcy proceedings under the Bankruptcy Code, including proceedings under Chapter 7, Chapter 11, Chapter 12 and Chapter 13.

the date of the Title 11 case, and the second of which begins on the commencement date of the Title 11 case. This election must be made on or before the due date for the earlier of the two tax returns, and, once made, is irrevocable.

ii. Note – Title 11; Loss of Attributes. The bankruptcy estate succeeds to certain tax attributes of the debtor, including (1) net operating loss ("NOL") carryovers; (2) carryovers of excess charitable contributions; (3) tax benefit items under IRC Section 111; (4) carryovers of any credits; (5) capital loss carryovers; (6) the basis, holding period and character of assets; (7) the method of accounting; (8) unused passive activity losses and credits; and (i) unused "at-risk" losses. However, as to administration expenses of the estate, the debtor cannot use these deductions to the extent not utilized by the estate. (IRC Section 1398(h)(2)(D).)

c. Insolvency. A debtor may fully exclude CODI from taxable income where such debtor is insolvent both before and after cancellation of the debt. (IRC Section 108(a)(1)(B).) For purposes of IRC Section 108, "insolvency" means the excess of liabilities over the fair market value of assets, all of which is to be measured immediately before the discharge. There is "income on the forgiveness of that indebtedness only to the extent that the fair market value of [the taxpayer's] assets exceeded [the taxpayer's] total liabilities immediately following the forgiveness." (*Estate of Marcus v. Comm.* (T.C. Memo 1975-9.)

The measure of insolvency includes assets that are otherwise exempt from the claims of creditors under state law. (*Carlson v. Comm.* (2001) 116 TC 87.) The term "liabilities," for purposes of IRC Section 108(d)(3), means obligations that are classified as liabilities under financial accounting standards. *Merkel v. Comm.* (1997) 109 TC 463, affd 192 F.3d 844 (9th Cir. 1999). Contingent liabilities are includible in determining insolvency—probably the taxpayer will be called upon to pay.

Thus, whether a taxpayer is insolvent for purposes of this exception is determined according to the taxpayer's balance sheet. The amount of CODI excluded from income for purposes of the "insolvency exception" is limited to the amount by which the taxpayer is insolvent, both before and after the discharge.

d. Qualified Real Property Business Indebtedness ("QRPBI"). In addition to the bankruptcy and insolvency exceptions, a taxpayer/debtor (other than a C corporation) who or which is not otherwise bankrupt or insolvent (within the meaning of IRC

Section 108) may, nonetheless, exclude from gross income all or a portion of income derived from the discharge of QRPBI.

The amount of CODI that the taxpayer elects to exclude will reduce the basis of the taxpayer's depreciable real property. The election is made by filing Form 982 with the taxpayer's timely filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has CODI. Basis must be reduced in the following order: (1) real property used in a trade or business or held for investment that secured the discharged QRPBI, other than real property described in IRC Section 1221(l) real property held primarily for sale to customers in the trade or business); and (2) other property used in a trade or business or held for investment other than real property described in IRC Section 1221(l). In other words, only the adjusted basis of depreciable real property can have their basis further reduced for purposes of IRC Section 108(a)(1)(D) and (C). If there are multiple properties in any class of property, then their basis are reduced in proportion to such basis.

> *Example. The foreclosure of land secured by recourse QRPBI resulted in CODI of $600. Because of the foreclosure, taxpayer has no category 1 assets. Taxpayer has 3 properties in category 2, property 1 with a basis of $800, property 2 with a basis of $100 and property 3 with a basis of $300. The $600 of basis reduction is allocated among the three properties in proportion to their respective basis. Thus, property 1 takes a basis reduction of $400 ($800/$1,200 x $600), property 2 takes a basis reduction of $500 (100/$1,200 x $600), property 3 takes a basis reduction of $150 ($300/$1,200 x 600).*

The amount of discharge of QRPBI which may be excluded from a taxpayer's gross income is subject to the following two limitations:

i. the amount excluded cannot exceed the aggregate adjusted basis of the depreciable real property held by the taxpayer immediately preceding the discharge (IRC Section 108(c)(2)(B)); and

ii. the amount excluded cannot exceed the excess of (i) the outstanding principal amount of the debt (immediately preceding the discharge), over (ii) the fair market value of the property securing the debt (immediately preceding the discharge), reduced by other qualified real property indebtedness secured by such property. (IRC Section 108(c)(2)(A).)

Example. *Individual A (who is neither bankrupt nor insolvent) owns a building worth $140,000, used in his trade or business that is subject to a first mortgage securing a debt of A's of $100,000 and a second mortgage securing a second debt of A's of $90,000. Neither debt is qualified farm indebtedness. A agrees with this second mortgagee to reduce the second mortgage debt to $30,000, resulting in CODI in the amount of $60,000. Assuming that A has sufficient depreciable basis in business real property to absorb the reduction, A can elect to exclude $50,000 [the difference between the total debt ($190,000, or $100,000 plus $90,000) and the fair market value of the property ($140,000)] of that CODI. A will have $10,000 ($60,000 debt forgiven -- $50,000 exclusion) of taxable CODI.*

For purposes of IRC Section 108, QRPBI is defined as debt that:

(1) is incurred or assumed in connection with real property used in a trade or business;

(2) is secured by such real property; and

(3) with respect to which the taxpayer has made an election under IRC § 108.

QRPBI does not include indebtedness incurred or assumed on or after January 1, 1993, unless such debt is (a) incurred to acquire, construct or substantially improve the real property securing such debt (referred to as "qualified acquisition indebtedness") or (b) incurred to refinance qualified real property business debt incurred or assumed before January 1, 1993 (but only to the extent that the amount of the debt does not exceed the amount being refinanced). In addition, qualified farm indebtedness under IRC Section 108(g) is not considered QRPBI. Any change made in the property securing debt within one year of the discharge of the debt, where the principal purpose is to affect basis reductions, will be ignored.

(a) Partnerships and S Corps: For partnerships, whether debt is considered QRPBI is made at the partnership level. While the election to reduce the basis of property is made at the partner level, basis will be reduced at a partnership level. However, with respect to S corporations, the election to reduce the basis of property is made by the S corporation (IRC § 1363(c)(1)), and the exclusion and basis reduction are both made at the S corporation level.

e. Impact of Bankruptcy or Insolvency on Tax Attributes. Unless the taxpayer elects first to reduce the basis of his or her depreciable assets by the amount excluded from gross income (as discussed below), taxpayers having debts discharged pursuant to either the bankruptcy or the insolvency exception are required to reduce (by the

amount of the discharged debt) the following tax attributes (in the following order of priority):

i. NOL and NOL carryovers;

ii. General business credit carryovers under IRC § 38;

iii. Minimum tax credits under IRC Section 53(b);

iv. Capital losses and capital loss carryovers;

v. The basis of the taxpayer's assets;

vi. Passive activity losses and credit carryovers under IRC § 469; and

vii. Foreign tax credit carryovers under IRC Section 27.

However, rather than have tax attributes reduced, a taxpayer may elect to first reduce the adjusted basis of certain depreciable property (even if a QRPBI election is not made). The amount of such reduction in basis is limited to the aggregate adjusted basis of the taxpayer's depreciable property as of the beginning of the taxable year following the taxable year of the discharge. In addition, with respect to the discharge of QRPBI, the amount of the basis reduction may not exceed the excess of the outstanding principal amount of the debt over the fair market value of the property securing such debt.

f. Gifts. There is also no CODI where the forgiveness was intended as a bona fide gift. This exception is usually applicable only in the family situation (e.g., an employer cancellation of a loan to employee probably would not qualify). A gift in the form of forgiveness of debt will not result in income to the debtor, but it may cause the creditor to recognize income if the indebtedness cancelled is an installment obligation. Further, the creditor may have to pay gift tax.

g. Purchase Money Indebtedness. Where the mortgage debt is a purchase money mortgage and there is a reduction in the purchaser's obligation, there is no CODI, but a purchase price reduction (IRC § 108(e)(5).). For this provision to apply, the purchase money debt must be owed to the seller/creditor of the property. The debtor can be neither insolvent nor bankrupt.

However, it is the IRS's position that a reduction in the principal balance of a nonrecourse debt by a holder who was not the seller results in CODI, irrespective of whether the fair market value of the property is greater or less than the balance of the debt at the time of the principal reduction. (Rev. Rul. 91-31, 1991-1 CB 19, amplifying Rev. Rul. 82-2002,

1982-2 CB 35.) The IRS has not adopted <u>*Fulton Gold* Corp. v. Comm.</u> (1934) 31 BTA 519, where the satisfaction of a nonrecourse mortgage for an amount less than its face amount was allowed as a reduction of the mortgagor's basis in the underlying property (which did not trigger the realization of income).

h. <u>Stock-for-Debt Exception</u>. Prior to the enactment of the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993"), IRC Section 108(a)(10) provided that a corporation that issues stock to a creditor in satisfaction of outstanding indebtedness will not be required to recognize CODI or a reduction in its tax attributes if such corporate debtor was bankrupt or otherwise insolvent at the time and the stock issued was not "disqualified stock."

However, under OBRA 1993, the "stock-for-debt" exception was generally repealed, and, as a result, the transfer of stock by a corporate debtor to a creditor in satisfaction of debt gives rise to CODI to the extent that such debt exceeds the fair market value of the stock transferred. Notwithstanding the repeal of the stock-for-debt exception, a bankrupt or insolvent corporation may still exclude all or a portion of its CODI created by its transfer of stock by reducing its tax attributes (in the order previously described).

i. <u>Abandonment</u>. Another strategy (although not without risk or complexity) is to abandon troubled real property that is held for investment or part of a trade or business.

i. <u>General Rule - Abandonment</u>. Generally, IRC Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. IRC Section 165(b) states that the amount of the deduction for a loss is the adjusted basis as provided in IRC Section 1011. See also Section 1.165-1(c) of the Income Tax Regulations ("Regs"). Regs Section 1.165-1(b) provides that, to be allowable as a deduction under IRC Section 165(a), a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event, and, except as provided in IRC Section 165(h) and Regs Section 1.165-11, actually sustained during the taxable year. Regs Section 1.165-1(d)(1) provides that a loss is treated as sustained during the taxable year in which the loss occurs, as evidenced by a closed and completed transaction, and as fixed by an identifiable event occurring in such taxable year.

ii. <u>Manifestation of Abandonment</u>. IRC Section 165 losses have been referred to as abandonment losses to reflect that some act is required that

evidences a taxpayer's intent to permanently discard or discontinue use. *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396, 402 (3d Cir. 1990). To establish the abandonment of an asset for purposes of IRC Section 165, a taxpayer must show both (1) an intention to abandon the asset, and (2) an affirmative act of abandonment. *A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); *CRST, Inc. v. Commissioner,* 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990); Rev. Rul. 93-80, 1993-2 C.B. 239. Abandonment should be accompanied by some express manifestation. *Citron v. Commissioner*, 97 T.C. 200, 209 (1991). See also *Echols v. Commissioner,* 935 F.2d 703, 706-08 (5th Cir. 1991) (finding both an intent to abandon and an affirmative act of abandonment when taxpayers called a partnership meeting at which they tendered their 75% partnership interest to another partner, or anyone else, "gratis," and announced that they would contribute no further funds to the partnership), reh'g denied, 950 F.2d 209 (5th Cir. 1991).

The "identifiable event" required by Regs Section 1.165-1(b) and (d)(1) "must be observable to outsiders and constitute 'some step which irrevocably cuts ties to the asset.'" *United Dairy Farmers, Inc. v. U.S.*, 267 F.3d 510, 522 (6th Cir. 2001) (quoting *Corra Resources, Ltd. v. Commissioner,* 945 F.2d 224, 226 (7th Cir. 1991)). Mere non-use of an asset is not sufficient to establish an act of abandonment. *Standley v. Commissioner,* 99 T.C. 259, 272 (1992), aff'd without published opinion, 24 F.3d 249 (9th Cir. 1994). Similarly, internal communications or decisions within a taxpayer's organization are not sufficient affirmative acts of abandonment. See *Corra Resources,* 945 F.2d at 226.

iii. Real Property Abandonment. With respect to real property, a deduction for worthlessness has been either a separate claim for deduction or merely an element used as one of the underlying facts establishing the basis for an abandonment wherein there is some actual act of an abandonment or a disposition. *Thor Power Tool Co. v. Commissioner,* 439 U.S. 522, 542-44 (1979). While a taxpayer need not relinquish legal title to property in all cases to establish abandonment, provided there is an intent to abandon and an affirmative act of abandonment, it is upon the taxpayer to prove the abandonment. See *Echols*, 935 F.2d at 706; *Middleton v. Commissioner,* 77 T.C. 310, 322 (1981), aff'd per curiam, 693 F.2d 124 (11th Cir. 1982). For example, with respect to a damaged structure on property, retention of bare legal title to property does not preclude a deduction under IRC Section 165(a) in certain cases in which property has become worthless. See *Helvering v. Gordon*, 134 F.2d 685, 689 (4th Cir. 1943), acq., 1951-1 C.B. 2; *Rhodes v.*

Commissioner, 100 F.2d 966, 970 (6th Cir. 1939); Rev. Rul. 54-581, 1954-2 C.B. 112. On the other hand, because a mere diminution in the value of an asset is not sufficient to establish worthlessness even when they have no liquidated value, there is a reasonable hope and expectation that it will become valuable in the future. Accordingly, with respect to an entire ownership interest in real estate or a real estate holding entity, an abandonment is usually endeavored to be shown. *Proesel v. Commissioner,* 77 T.C. 992, 1006 (1981). See *Lawson v. Commissioner*, 42 B.T.A. 1103, 1108 (1940); *Morton v. Commissioner*, 38 B.T.A. 1270, 1278 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940); Rev. Rul. 77-17, 1977-1 C.B. 44. In fact, abandonment and other transactions that divest the taxpayer's title are identifiable events that support a closed and completed transaction. Additionally, abandonment may include identifiable events relating to worthlessness such as "other acts or events which reflect the fact that the property is not capable of rendering value." *Proesel*, 77 T.C. at 1005. It may include showing that particular event destroyed the potential value and usefulness of the asset to the taxpayer.

iv. Method of Abandonment. Revenue Ruling ("Rev. Rul.") 93-80, 1993-2 C.B. 239 outlined how an abandonment is made. In theory, abandonment is used where parties intend unconditionally to abandon an interest in property wherein the benefit is that there is no "sale or exchange" and the provisions of IRC Section 751, would do not apply (due to the absence of a sale or exchange). *Corra Resources,* 945 F.2d at 226-27 (loss realized in the year in which coal mining lease expired); *George Freitas Dairy, Inc. v. United States*, 582 F.2d 500, 502 (9th Cir. 1978) (cancellation of production quota contract was identifiable event that evidenced the closed and completed transaction). By contrast, a deduction is not allowable if a taxpayer intends to hold and preserve property for possible future use or to realize potential future value from the property. *A.J. Indus.,* 503 F.2d at 670.

v. Risk of Gain Recognition. To claim abandonment is not without substantial tax risk. In *Arkin v. Com'r,* (1981) 76 T.C. 1048, the Tax Court found that the abandonment of interests in a land trust would be treated as a sale/exchange under IRC Section 165(f) in light of the fact that the parties were no longer subject to potential liability resulting from tort or contract litigation associated with the property. While a more recent case did not involve an abandonment, *Arkin* has been cited affirmatively in a more recent decision. *L&C Springs Associates v. Com'r*, 74 TCM 928, 930 (1997).

vi. Advising Clients on Risk. With respect to troubled property, such as commercial retail or residential rental business or investment property, three is a position under IRC Section 165(a) for a deduction. However, taxpayers should be advised in undertaking an abandonment that, while there is supporting case authority, not all cases have allowed an abandonment, and therefore, claiming a loss is not without risk.

B. Debtor's Tax Consequences.

1. General Rule – Recourse Debt. Generally, the transfer of property pursuant to a foreclosure (or deed in lieu of foreclosure or other transfer to lender in full satisfaction of the debt) is treated, for federal income tax purposes, as a sale of property which may give rise to gain or loss to the debtor. (Regs Section 1.1001-2(a)(1), (2).)

Where property encumbered by recourse debt (that is, debt for which the debtor is personally liable) is foreclosed on, it is deemed to be sold for its fair market value, and any gain realized is bifurcated between (1) that portion allocable to the "sale element" of the transaction and (2) that portion allocable to the "debt cancellation element."

2. Nonrecourse Debt. Upon the foreclosure of property encumbered by nonrecourse debt, the property is deemed to be sold for the outstanding balance of the nonrecourse debt, irrespective of the fair market value of such property.

If the property is transferred to the creditor voluntarily in lieu of foreclosure, the difference between a foreclosure and a voluntary conveyance of a deed in lieu thereof was "too tenuous" to warrant any difference in tax treatment. (*Allan v. Comm.* (1986) 86 TC 655.)

> Practice Tip. Where a taxpayer with limited funds has both nonrecourse and recourse debt securing several real estate holdings imminently facing foreclosure, it generally would be more prudent to pay down the nonrecourse debt. The effect of paying down the recourse debt would be to reduce the possible discharge of indebtedness income, as opposed to IRC Section 1001 income. Discharge income may be excludible under one of the IRC Section 108 exceptions, whereas IRC Section 1001 income may have no offsetting loss items.

3. Tax Treatment. The tax treatment of property transferred to the creditor in the abandonment of property is unclear. Under earlier case law, if the taxpayer had an adjusted basis in the property exceeding the mortgage debt, then the taxpayer could recognize an ordinary loss upon his abandonment of such property, provided he could prove

both worthlessness of equity and, by some clearly identifiable event, abandonment in the year for which the deduction was claimed. (*Freeland v. Comm.* (1980) 74 TC 970.) However, more recent case law, following the *Freeland* decision, treated the abandonment of property subject to a nonrecourse mortgage as a "sale or exchange" of IRC Section 1231 property so that any gain or loss therefrom constitutes a capital gain or loss.

In spite of the holding in *Freeland,* two "recent" decisions have indicated that the abandonment of a partnership interest may be treated as an ordinary loss fully deductible by the taxpayer in the year the interest is abandoned. In *Citron v. Comm.* (1991) 97 TC 200, the taxpayer contributed $60,000 to a limited partnership formed to produce a motion picture. When the production of the film failed, the taxpayer renounced his interest in the partnership and claimed an ordinary loss in the year of the partnership's dissolution. The Tax Court held that the actions of the taxpayer in voting to dissolve the partnership and his communication to the general partner that he no longer owned an interest in the partnership or the motion picture sufficiently evidenced taxpayer's intention to abandon his partnership interest. Further, the Tax Court held that, because no partnership liabilities existed at the time taxpayer renounced his partnership interest, taxpayer could not be said to have been constructively paid any consideration for his partnership interest. Consequently, the Court held that no sale or exchange occurred on the abandonment, and so the taxpayer's abandonment loss was an ordinary loss in the year of the partnership's dissolution.

Similarly, in *Echols v. Comm.* (1989) 935 F.2d 703 (CA 5-1991), revg 93 TC 553, the taxpayer invested in a limited partnership which owned unimproved land subject to nonrecourse debt. When the value of the land plunged, the taxpayer informed the other partner that he could no longer carry his share of partnership expenses and would make no further contributions to the partnership. The taxpayer further stated that he was foregoing his interest in the partnership and would transfer such interest to anyone willing to assume his share of the partnership debt. The Circuit Court held that the taxpayer's statement to the other partner that he would make no additional capital contributions to the partnership was a "clear and unequivocal indication to [the other partner] and the world" that the taxpayer was "walking from his ownership interest." As a result, the Court held that the taxpayer's partnership interest was abandoned in the taxable year in which it was deemed worthless by the taxpayer, and so he was entitled to deduct an ordinary loss under IRC Section 165(a).

While the courts in *Citron* and *Echols* held that the taxpayer had abandoned his partnership interest, the issue of whether and when an abandonment has occurred generally involves a subjective assessment of all relevant facts and circumstances of a particular situation. Thus, in the absence of an easily ascertainable event, an abandonment may be difficult to prove.

4. Timing of Mortgagor's Tax Consequences. A loss on foreclosure is deductible in the year in which under state law, the taxpayer's right of redemption expires. (*Derby Realty Corp. v. Comm.* (1937) 35 BTA 335.) If there is no right of redemption, the deduction is taken in the year of the foreclosure sale, rather than in the year of the final decree. In addition, if the debtor wants a deduction in the year of foreclosure and has a right of redemption, he may voluntarily quitclaim his right to the same in order to obtain the deduction.

If there is a voluntary conveyance in lieu of foreclosure or abandonment, the loss is taken in the year such voluntary conveyance or abandonment occurs.

C. Impact on Lender.

1. General Rule. Where there is a cancellation of indebtedness or a satisfaction of a mortgage debt at less than its face amount, and there is no mortgage foreclosure, deed in lieu thereof or abandonment, the lender will realize a loss to the extent that its tax basis for the debt exceeds the amount actually paid. If incurred in a trade or business, this loss is deductible whether or not the mortgagor is able to repay the mortgage debt in full and whether or not the value of the mortgaged property has increased or decreased.

Note that, if the mortgage note were issued, taken or acquired at a discount, the lender/note holder could have a gain, rather than a loss, on the debt settlement. This would occur if the settlement were for an amount more than the tax basis for the note, although less than the face amount.

A corporate lender always has a business bad debt, resulting in ordinary loss treatment.

A noncorporate lender may receive ordinary loss treatment, but only if the debt was a business debt. (IRC Section 166(d)(1).) A business debt is either a debt created or acquired in connection with a trade or business of the taxpayer or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. The characterization

of a worthless debt as business or nonbusiness is a question of fact which depends on the relationship between the debt and the creditor's trade or business. The test for determining what constitutes a "trade or business" for purposes of applying IRC Section 166 is the same as that used for ascertaining the deductibility of a loss under IRC Section 165—that is, whether the loss is proximately related to the conduct of the trade or business of the taxpayer.

2. Wholly Worthless Bad Debts. Generally, a bad debt that is wholly worthless is deducted in full in the year in which such worthlessness occurs. (IRC Section 166(a)(1); Regs Section 1.166-3(b).) While legal action to enforce payment is not necessary where the facts indicate that such action would be futile, the factors considered by the courts and the Service have included: (i) receivership or bankruptcy of the debtor; (ii) the termination of, or decline in, the debtor's business; (iii) the debtor's disappearance of departure from the country; and (iv) the debtor's death.

3. Partially Worthless Bad Debts. As a general rule, a partially worthless debt is deductible in the taxable year in which it is determined that only a portion of the debt is recoverable; the worthless portion is deductible to the extent that it is charged off in such year. (IRC Section 166(a)(2).) The worthlessness of the portion charged off must be established to the satisfaction of the Service. In this connection, the courts have held that the determination of the Service, if reasonably based on the facts, will not be overturned unless arbitrary or unreasonable.

The burden is on the taxpayer to prove that a proper charge-off was made. The entries actually charging off the partially worthless debt need be made prior to the filing of the income tax return for that year.

4. Noninvestment Loss – Personal Loan. IRC Section 165 does not apply to individuals where the loss is not (i) incurred in a trade or business or (ii) in any transaction entered into for profit. Consequently, worthless debt to on a real estate loan to family member may be treated as a short-term capital loss.

D. Exception: Seller Reacquisitions Under IRC Section 1038.

Generally, when a purchaser under a purchase money mortgage defaults, the seller, either by foreclosure or by voluntary conveyance of a deed in lieu of foreclosure, reacquires the property formerly owned. In situations where the value of the real property at the time of the reacquisition is greater than the seller's adjusted basis for the mortgage debt in default, IRC Section 1038 determines the tax consequences.

In general, IRC Section 1038 applies where a sale of real property results in seller acceptance of a promissory note from the buyer which is secured by the real property sold, and the seller subsequently reacquires such real property in partial or full satisfaction of such indebtedness. In such cases, generally no gain or loss (which, but for IRC Section 1038, would be measured in accordance with IRC Section 1001 by the difference between the fair market value of the property and the seller's basis in the indebtedness) will result to the seller on such reacquisition.

IRC Section 1038 applies only to real property, and not to personal property. Thus, if the property sold included elements of both real property and personal property, it would be necessary, upon reacquisition, to separate both the basis of the personal property sold and the value of the personal property reacquired, for there would be gain or loss resulting, under the general income tax rules noted above, with respect to such personalty.

The reacquisition must be in partial or full satisfaction of the debt. "That is, the reacquisition must be in furtherance of the seller's security rights in the property with respect to indebtedness to him that arose at the time of the sale." However, IRC Section 1038 may be applied notwithstanding the fact that default has neither occurred nor is imminent or the purchaser and seller are related parties.

The manner in which the seller reacquires the real property is generally immaterial. There is no requirement that the property be reacquired from the original purchaser, inasmuch as no mention is made in IRC Section 1038(a) of the "purchaser."

While IRC Sections 1038(b) and (d) set forth the rules as to the recognition of gain in certain situations, IRC Section 1038(a) specifically provides that under no circumstances will any loss be recognized where IRC Section 1038 is applicable. Thus, if it is desirable for the seller to recognize a loss, one or more of the requirements of IRC Section 1038 must be broken.

IRC Section 1038(b)(2) places a ceiling on the amount of taxable gain as a result of reacquisition. In no event is the gain attributable to payments received before repossession to exceed (i) the potential gain attributable to the initial sale (that is, the amount by which the selling price of the real property exceeded its adjusted basis in the hands of the seller), reduced by (ii) the sum of (a) any amounts received before repossession already reported as income and (b) the amount of money and the fair market value of other property (except purchase money obligations of the purchaser) paid or transferred by the seller in connection

with the reacquisition. In determining the potential gain attributable to the initial sale, the gross selling price is reduced by selling commissions, legal fees and other expenses incident to the sale.

When the property is reacquired, and such first mortgage is assumed or taken subject to, the unpaid balance of the first mortgage, so long as the first mortgage did not arise when the seller owned the property, will be treated as money paid by the seller on the reacquisition, thereby increasing basis. (Regs § 1.1038-1(c)(4)(ii).)

If the purchaser made improvements to the property, the reacquisition produces two holding periods for the seller. Tacking is permitted for the portion of the property not improved by the purchaser; however, the holding period of the improved portion is not tacked but is limited to the period beginning with the date of reacquisition. A separate holding period for improvements would also be required if they were constructed by the seller after the reacquisition.

No bad debt deduction is allowed as a result of the reacquisition. (Regs § 1.1038-1(f)(1).) Moreover, if the seller claimed a deduction for the complete or partial worthlessness of the purchaser's obligation prior to the reacquisition, the deduction must be "reversed" upon the reacquisition. Under IRC Section 1038(d), the seller realizes income on the reacquisition equal to the amount of the prior bad debt deduction, and the adjusted basis of the indebtedness is increased, as of the date of reacquisition, by a like amount.

Finally, if the property sold was the seller's principal residence, gain on the sale may have been excluded.

E. Partnerships and CODI.

1. Introduction. A financially troubled partnership may realize CODI or realize a gain or loss on the disposition, or a combination of both if its property is sold at a foreclosure sale or to a third party, the partnership abandons property (such as by quit claim deed or a tax sale), or the partnership reconveys the property to the lender (that is, deed in lieu of foreclosure). As previously indicated, for all properties, the character will depend on whether the debt is recourse or nonrecourse.

While the determination of the existence or amount of CODI and the amount of sale/exchange gain or loss are both made at the partnership level, the taxability is determined at a partner level. This means that each partner's distributive share of CODI and sale or exchange gain is separately stated on his or her Schedule K-1.

This separation causes some confusion in circumstances as to certain “exclusions” wherein the amount of income is not really excluded, but rather is not considered CODI. For example, when a cash basis taxpayer’s obligation to pay an expense is cancelled, IRC Section 108 provides that, because payment of the debt would have given the taxpayer a deduction, then the taxpayer does not realize CODI under IRC Section 108(e)(2). It would seem that this should be determined at a partnership level. Alternatively, if seller financed debt is reduced for a solvent taxpayer, the reduction is treated as a purchase price reduction and not CODI. (IRC Section 108(e)(5).) These would seem to be items determined at the partnership level.

As to the partner level determination of exclusions, partners must include CODI in taxable income unless an exception applies. (IRC Sections 61(a)(12); 108(d)(6) and 6231(a)(5).)[3] A partner may exclude CODI under IRC Section 108 if:

a. Partner is bankrupt;

b. Partner is insolvent;

c. Qualified farm indebtedness is canceled; or

d. Debt is QRPBI, the partner is not a C corporation, and the partner elects to reduce his or her basis in depreciable real property.

2. Insolvency. If a partner is insolvent, then he or she may exclude CODI income to the extent insolvent. (IRC Sections 108(a)(1)(B) and 108(a)(3).) If the cancellation of debt removes a partner from insolvency, the partner must recognize income to the extent made solvent. That is, to the extent the fair market value of the partner’s assets exceeds his or her liabilities immediately after the cancellation.

a. Measuring Insolvency. Insolvency is determined based on a balance sheet test determined immediately before discharge. (IRC Section 108(d)(3).) For purposes of this test, the amount by which a non-recourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent, but only to the extent that the excess non-recourse debt is discharged. (Rev. Rul. 92-53.) In addition, the fair market value of assets that are exempt under state law are not excludable in determining insolvency. Contingent liabilities

[3] Documentation is critical here. Under the IRS Field Audit Manuel, the IRS audit examiner is instructed to prepare documentation wherein additional factual determinations are required at the partner level.

(guarantees) are generally not included in the insolvency computation. *Merkel*, 109 T.C. 463 (1997), aff'd, 99-2 U.S.T.C. Par. 50,848 (9th Cir. 1999).[4]

3. Real Property Partnership Abandonment. The alternative of an abandonment, as indicated above, becomes more interesting in the context of a partnership interest. Again, there must be proven both an intent to abandon and an affirmative act of abandonment. (*Citron v. Com'r,* (1991) 97 T.C. 200)

a. Echols Decision. In *Echols v. Com'r,* 935 F.2d 703, 707 (5th Cir. 1991), taxpayer claimed abandonment upon default to the partnership on certain property acquired by buyer. The partnership ultimately defaulted on the loan and the seller foreclosed on the property. The *Echols* court concluded that the taxpayer was entitled to an abandonment loss deduction with respect to their partnership interest as they expressly stated their desire not to contribute further to the partnership and to give up their partnership interest coupled with their subsequent acts of not fulfilling their partnership obligations. In *Hutcheson v. Com'r,* 17 TC. 14 (1951), withdrawing partners were allowed ordinary loss treatment with respect to their capital interests.

b. Effect of Abandonment of Partnership Interest. As discussed above, the *Arkin* decision indicates that the characterization of an abandonment where the partnership is subject to debt is unclear. In addition, even without *Arkin,* any actual or deemed distribution in connection wit the abandonment of a partnership interest could invoke the deemed distribution rules under IRC Section 731. Except for IRC Section 751(b), the deemed distribution could result in capital loss. Rev. Rul. 93-80, 1993-2 C.B. 239.

4. Qualified Real Property Business Indebtedness. Solvent partners, other than C corporations, may exclude cancellation of QRPBI income if certain requirements are met. (IRC § 108(c).)

a. The determination of whether canceled debt is QRPBI is made at the partnership level. The debt cancelled must be secured by real property used in the trade or business and incurred before January 1, 1993, or be Qualified Acquisition Indebtedness.

b. The excluded CODI cannot exceed the partner's share of the difference between the outstanding principal amount of debt (before discharge) and the fair-

[4] The burden of proving insolvency is on the taxpayer. Bressi, T.C. Memo 1991-651.

market value of the real property (reduced by the outstanding principal amount of any other QRPBI secured by such property); and the partner's total adjusted basis of depreciable real property. The outstanding principal amount includes prior year accumulated accrued and unpaid interest. (Regs Section 1.108-6(a).)

c. The adjusted basis of qualified real property (whose debt was reduced) must be reduced by discharged QRPBI before the adjusted basis of other depreciable real property are reduced. (Regs Section 1.1017-1(c)(1).)

d. The basis of property acquired in contemplation of indebtedness may not be reduced.

e. The partner must make a timely election to reduce the basis of his or her depreciable real property. (Note: Depreciable real property does not include land, furniture and fixtures, equipment or intangible assets). A partnership interest is considered depreciable real property to the extent of the partner's share of depreciable real property. To make the election, the partner uses Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, in the year CODI is received. The partner must attach a detailed description, by property, identifying any reduction in basis under IRC Section 1017.

f. For the partner's basis in his or her partnership interest to be reduced the partnership must make a corresponding reduction in the partner's share of depreciable real property on its books. **WARNING:** If the partnership does not make the reduction, the partner may not exclude the CODI. (See Regs Section 1.1017-1(g)(2) for general rule and exceptions.)

g. The partnership must consent to the reduction of partner's share of inside basis if: (i) the partner owns (directly or indirectly) more than 80 percent interest in the capital and profits of the partnership; or (ii) five or fewer partners own (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. (See Regs Section 1.1017-1(g)(2)(ii)(C).)

5. Partnership Consent Statement (Regs § 1.1017-1(g)(2)(iii)).

a. Partnership Requirements.

i. Statement must be attached to partnership return (Form 1065) for the taxable year following the year that ends with or within the taxable year the partner excludes CODI.

ii. Statement must be provided to the partner on or before the due date of the partner's return (including extensions) for the taxable year in which the partner excludes CODI.

iii. Statement must contain the following:

(a) Name, address, and taxpayer identification number of the partnership; and

(b) States the amount of the reduction of the partner's proportionate interest in the adjusted basis of the partnership's depreciable real property.

b. Partner Requirements.

i. The partnership consent statement must be attached to the partner's timely filed (including extensions) tax return for the taxable year in which the partner excludes CODI.

ii. If the property whose debt is reduced is sold in the same year as the debt cancellation, IRC Section 1017(a)(3)(F) requires that the basis reductions be effected immediately before the sale. As a result, basis reductions will be immediately triggered into income (as ordinary income due to IRC Section 1245) upon the sale. (IRC Section 1017(b)(3)(F)(iii).) This immediate recapture normally will take any tax benefit away from IRC § 108(c).

6. Example.

In 1998, Partnership restructured its debt and realized CODI of $500,000. All partners elected to reduce the basis of their partnership interests (considered depreciable real property). On December 30, 1998, Partnership sold all of its real property for $1 million. Prior to the QRPBI basis reduction the adjusted basis of Partnership's real property was $500,000 for the building and $100,000 for the land. The Partnership computed its gain on disposition of real property as follows:

Sales Price		**$1,000,000**
Adjusted Basis before QRPBI Reduction	$500,000	
QRPBI Reduction	(500,000)*	
	-0-	
Land	100,000	
Adjusted Basis		**(100,000)**
Gain on sale/exchange		**$ 900,000***

**$500,000 of gain is considered ordinary income. (IRC § 1245.) The balance of the gain is IRC § 1231 gain.*

7. CODI Excluded Under IRC § 108(a)(1)(A), (B), (C). Cancelled debt that is not taxed because a taxpayer is bankrupt, insolvent, or has qualified farm indebtedness discharged cannot be passive income on Form 8582. Passive income is only income that is taxed in the current year. If cancelled debt is taxable income under IRC Section 61(a)(2), it may be passive income.

However, CODI excluded under IRC Section 108(a)(1)(A), (B), or (C) will reduce tax attributes of the taxpayer. (IRC Section 108(b).) Passive activity loss and credit carryovers are considered tax attributes.

8. Taxable CODI (IRC Section 61(a)(12) and Gain on Foreclosure or Sale (IRC Section 61(a)(3). Generally, taxable CODI is passive to the extent it is allocated to passive activity expenditures at the time the debt is discharged. While Rev. Rul. 92-92, 1992-2 C.B. 103 addressed CODI as passive activity income upon delivery of a deed in lieu of foreclosure on recourse debt, a similar result would occur upon a foreclosure.

There are some exceptions to the general rule. In the following cases CODI or gain on foreclosure or sale of property should be considered non-passive income and should not be on Form 8582 line 1a or 2a.

a. Partner is a real estate professional and materially participated in the partnership rental activity in the year income or gain is recognized. (See IRC § 469(c)(7) and Regs 1.469-9.)

b. CODI and/or gain on foreclosure or sale of property are non-passive if the property was leased to an entity where the investor worked (that is, materially participated—the self-rental recharacterization rule). See Regs § 1.469-2(f)(6).)

c. CODI and/or gain on foreclosure or sale of property are non-passive if less than 30 percent of the unadjusted basis is depreciable. Income from land, whether held for investment or leased or sold, is non-passive. (See IRC § 469(3)(1)(A)(ii)(II) and Regs § 1.469-2T(f)(3).)

d. In the year of disposition, CODI income and/or gain on foreclosure of sale of property is recognized but the partnership is not a rental activity or business. See Regs § 1.469-2T(c)(2)(A)(I)(3). Whether or not property is rented in the year of disposition is easy to determine. Simply review Form 8825 for rental income and/or advertising expense.

e. Even if CODI income and/or gain on foreclosure or sale of property is determined to be passive, it does not belong on Form 8582, triggering unrelated passive losses, if current and suspended losses from the activity disposed of exceed income/gain reported from the activity. (See IRC § 469(g).)

Section 469(g) permits the deductibility of all current and suspended losses if there is an entire disposition of a partnership interest in a fully taxable transaction to an unrelated party. Thus, whether or not the character of income attributable to canceled debt and/or gain on foreclosure/sale is passive or non-passive, all losses (current and suspended) from the partnership will be deductible. If the amount or timing of CODI and/or gain on foreclosure/sale has yet to be determined, there is not a "fully taxable" disposition (that is, all gain/loss realized and recognized) as required by IRC § 469(g). Any legitimate passive income will, of course, trigger deductibility of losses.

9. Conversion of Debt Into Equity. While by its terms IRC Section 108(e)(8) is inapplicable to partnerships, there may be a position to not recognize CODI if a partnership interest is issued in exchange for debt in a value equal to the amount of the debt provided that the debt is unrelated to services. On the other hand, debt cancellation may result in deemed distributions under IRC Sections 752 and 733, resulting gain to the existing partners. (In addition, a partnership's minimum gain chargeback may be reduced to zero where nonrecourse debt is converted.)

10. Allocation of CODI. Where there is CODI, the allocation to the partners will be subject to the tax law on allocation, including that the allocations have substantial economic effect, IRC Section 704(c) – basis-fair market value differences on contributed property and partnership minimum gain requirements.

Any allocation of CODI has corresponding implications. First, while CODI would represent income, even if exempted by a partner's insolvency that would both (i) increase partner's basis, and (ii) reduce basis by any deemed distribution for reduction of debt under IRC Section 752(b). If the allocations of CODI are consistent with the partners' allocable share of liabilities, the deemed distribution should not trigger gain since the increase and decrease in basis should then be self-cancelling.

Rev. Rul. 99-43, 1999-2 C.B. 506 provides that a special allocation of CODI to an insolvent partner will not be respected where the partnership agreement is amended after CODI has been realized.

F. S Corporations.

CODI from an S corporation is a separately stated item, i.e., a corporate item. If excluded due to an S corporation insolvency, it is an item of tax-exempt income under IRC Section 1366(a)(1)(A), which passes through under IRC Section 1367(a)(1)(A). The problem, however, is whether the CODI increases tax basis. In *Gitlitz v. Commissioner* (2001) 531 US 206, 148 L.Ed.2d 613, 121 S.Ct. 701, revg 182 F.3d 1142 (CA10 1999), the Supreme Court held that (i) CODI passes through to the shareholders of an insolvent S corporation; (ii) increases the basis of the shareholders (for purposes of deducting suspended losses); and (iii) and reduction in the tax attributes (including NOL).

However, the Job Creation and Worker Assistance Act of 2002 amended IRC Section 108(d)(7)(A) so that CODI which is excluded from the gross income of an S corporation will not result in an adjustment to the stock basis of such shareholder. The amended provision is effective for CODI arising in taxable years ending after October 11, 2001.[5]

III. Mortgage Forgiveness Debt Relief Act of 2007.

A. Temporary" Relief for Discharge of "Qualifying Indebtedness."

The Mortgage Forgiveness Debt Relief Act of 2007 amended the Code to, among other things:

[5] However, IRC Section 108(d)(7)(A), as amended, does not apply to any discharge of indebtedness before March 1, 2002, which occurs pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

1. Exclude, prior to January 1, 2010, a discharge of "qualifying indebtedness", provided the discharge is directly related to a decline in the value of the (principal) residence or to the financial condition of the taxpayer. However, the basis of the residence securing the qualifying indebtedness will be reduced by the amount of discharged indebtedness excluded from gross income.

a. "Qualifying indebtedness" is the first $2 million of excess indebtedness incurred to buy, build or improve a principal residence. Qualified residence and principal residences are based on the $1 million limitation (rest for $2 million) for the interest deduction rules. Any debt, i.e., from a refinance, will not qualify.

2. Set forth rules for determining the allowable amount of the exclusion for taxpayers with nonqualifying indebtedness and taxpayers who are insolvent.

3. Extend through 2010, the tax deduction for mortgage insurance premiums.

4. Allow a surviving spouse to exclude from gross income up to $500,000 of the gain from the sale or exchange of a principal residence owned jointly with a deceased spouse if the sale or exchange occurs within 2 years of the death of the spouse and other ownership and use requirements have been met.

IV. Summary/Recap of the Tax Rules Relative to Dealing with Distressed Properties and CODI.

A. 3 Basic Rules to Know.

1. A lender's agreement to write-down debt triggers cancellation of indebtedness income ("CODI") to a borrower. (IRC § 61(a)(12)).

2. Sales, foreclosures and deeds in lieu of foreclosure on nonrecourse debt are all sales of property.

a. The "sales price" upon a foreclosure or deed in lieu of foreclosure is the amount of nonrecourse debt forgiven – gain or loss is determined thereon.

b. The simultaneous cancellation of debt due to the foreclosure on a nonrecourse loan is not treated as CODI.

3. Insolvency, bankruptcy and other exceptions to CODI are available only if there is CODI.

B. Two Supreme Court Cases You Should Know.

1. *United States v. Kirby Lumber* 284 U.S. 1 (1931). The cancellation of indebtedness doctrine reflects a "freeing of assets." Ordinary income arises when there is a reduction of liabilities without a corresponding reduction in assets.

2. *Tufts v. Comm'r* 471 U.S. 300 (1983).

> Justice Blackmun: *"When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation. The fair market value of the property is irrelevant to this calculation."*

While not involving a foreclosure, due to the sweeping language of the Court's decision, the *Tufts* decision has been applied to foreclosures. Indeed, the Court rejected both amicus arguments that (1) loss should be realized (where the mortgage exceeds market value); and (2) the "cancellation of indebtedness" doctrine and insolvency exception were applicable.

C. Nonrecourse/Recourse Debt.

In California, home loans to acquire (purchase) up to 4 units—owner occupied, are nonrecourse (i.e., the borrower is not personally liable); this is true even if there is a personal promissory note (CCP § 580b.) On the other hand, a home loan may quickly convert to a recourse loan on a refinance, a commercial loan with a home as additional collateral (i.e. an SBA loan or a hard money commercial loan), or a purchase money loan outside of California.

D. Quick Guide—Personal Residences.

1. Nonrecourse Debt. The following strategies should be considered by homeowners "upside down" on their home equity.

a. Foreclosure or Deed in Lieu of Foreclosure. Under IRC Section 121, the taxpayer may be able to qualify to exclude $250,000 in gain (or $500,000 if married), if the property was held and used for two years as a personal residence. A loss, however, will not be allowed.

b. Short-Sale. A short sale involves the property holder selling property to a third party where the lender agrees to reduce mortgage settlement to the net

sales price—the bank is "shorted" on its payoff.[6] Involving neither a foreclosure or a deed-in-lieu, it is a modified sales arrangement. Even for nonrecourse debt, a short sale generates CODI wherein (i) the debt cancellation and (ii) the gain/loss on sale of the property are separately computed on a single transaction; the *Tufts* decision applies only to the sale portion.

i. The tax treatment of a short-sale is not entirely clear. Under Revenue Ruling 91-31, 1991-1 CB 19, a negotiated reduction of debt, including nonrecourse, non-seller purchase debt, produces CODI, regardless of the value of the collateral. The CODI will be taxable as ordinary income to the homeowner unless the insolvency or bankruptcy exceptions apply under IRC Section 108. CODI will not qualify for IRC Section 121.

On the other hand, in *Fulton Gold*, 31 B.T.A. 519 (1934), the Board of Tax Appeals allowed a basis reduction to the cost of the property rather than requiring taxable income to be reported upon the reduction of non-seller financed purchase debt.

While *Fulton Gold's* position is favorable, it is not without risk. The foundation for this decision involves a renegotiation of the purchase price between buyer and seller. But with non-seller financing, there is no renegotiation of purchase price with the seller. Therefore, if *Fulton Gold* is followed, appropriate tax return disclosure should be considered to avoid penalties under IRC Section 6662.

> *Example. In certain cases, a foreclosure may be preferable to a short-sale if it results in a better tax position. For example, assume that an individual purchases a home for $240,000 with a down payment of $40,000. Three years later, the property is worth only $170,000.*
>
> *Under Revenue Ruling 91-31, if the bank reduces the debt from $200,000 to $170,000, there is $30,000 of CODI. Unless there is an insolvency, a bankruptcy or other exemption, this CODI must be reported by the taxpayer. Unfortunately, a subsequent disposition of the property for $170,000 will result in a nondeductible personal loss of $70,000.*
>
> *If this is a personal residence, the result is $30,000 of CODI with no offset for the $70,000 loss. Had there been a foreclosure, there would have been the same economic loss but no taxable income.*

[6] By contract, when the property holder sells encumbered property to a third party, the third party assumes the full outstanding mortgage, and there is no debt reduction or short-sale.

Note that, following *Fulton Gold*, no CODI would be reported—the cancellation debt reduction would be treated as a reduction to the basis of the underlying property.

c. Conversion to Rental. If a loss is expected, the taxpayer may want to try to convert a personal residence to a rental property and hold onto the property "long enough" to convert any loss on a foreclosure to an investment loss. If held as a rental, a capital loss may be allowed (subject to annual loss limitations).[7]

d. Bankruptcy. Another option would be to consider a bankruptcy. Under a Chapter 7 proceeding, the homeowner's interest is to allow the foreclosure to occur through the bankruptcy estate to try to avoid recognition of any gain. With a nonrecourse debt, gain or loss on a foreclosure in bankruptcy is taxable to the bankruptcy estate. However, if the property is abandoned by the bankruptcy trustee and thereafter foreclosed upon, the gain is taxable to the taxpayer. Therefore, any relief from (nonrecourse) gain would have to come under IRC Section 121.

On the other hand, if the homeowner wants to retain the home while discharging other debts (e.g., an auto loan), a Chapter 13 proceeding may be considered (where the taxpayer must propose a workout arrangement to bring the loan current and meet all mortgage payments). Of course, failure to meet the payments set forth in the Chapter 13 plan will cause the plan to fail.

e. Workout. As another option, a client may try to negotiate a workout of the outstanding debt, including:

i. An interest rate reduction;

ii. An extension of the payment term; and/or

iii. A cancellation of some portion of the unpaid interest.

In a workout, not only the amount of forgiven loan principal, but any discharge of lender's attorney/collection/trustee fees will result in CODI (therefore, any exception to CODI recognition should be considered). Because cancellation of unpaid interest generally does not cause CODI (since that interest would generally give rise to a deduction) this is usually not a problem.

[7] While Regs § 1.167-1(g) limits the basis used to compute depreciation on rental property formerly held as personal residence to the lesser of (i) the cost basis or (ii) the fair market value of the property, this regulation limits the tax basis for reporting gain or loss upon a subsequent sale of the converted (former) personal residence rental use. Cases on deduction of a capital loss, such as *William C. Horrmann v. Com'r,* 17 T.C. 903, disallow loss for failure to convert the property to investment use.

f. Other Options. Homeowners may also consider the following other two strategies to try to reduce their economic strain, at least with respect to property taxes.

i. The elderly may consider deferral of one-half of their property taxes.

ii. Request a property tax reduction (Prop 8).

V. Recent Developments.

A. *Gilbert Hahn, Jr. and Margot H. Hahn v. Commissioner* (April 2, 2007) T.C. Memo 2007-75.

While not a real estate case, this decision highlights that CODI is not limited to loan principal and interest. Discharge of indebtedness income may include interest, taxes, penalties, and trustee and attorney fees, in addition to discharged principal, because the forgiveness of these related items result in an accession to income. Although income from the discharge of indebtedness income is not realized to the extent that the payment of a discharged liability would have given rise to a deduction, the evidence was not sufficient to show that the borrowed funds were in fact used in a trade or business.

B. *Great Plains Gasification Associates v. Commissioner* (December 27, 2006) T.C. Memo. 2006-276.

This decision clarified that where a foreclosure is disputed, the determination of CODI or gain does not occur until the year litigation is final.

A partnership was formed to develop, construct, own and operate a project to produce natural gas from coal. The partnership's assets were sold in a foreclosure sale in 1986, but litigation with the Department of Energy, the lender and buyer with respect to the sale continued through the end of the following year, when the Supreme Court denied the partnership's petition for a writ of certiorari on December 7, 1987. The IRS issued four identical assessments for 1985 through 1988, forcing the taxpayer to argue in court the year in which CODI arose. (Taxpayer reported 1987 as the proper year.) The Tax Court ruled that, although a foreclosure sale generally constitutes a disposition of property for tax purposes, if the matter is litigated, the year in which such litigation terminates is the year in which the claimed item is taken into account for federal tax purposes. The IRS's argument that the foreclosure litigation was not bona fide was rejected. Also, whether or not the

partnership could or would have redeemed the property would be based on speculation. Both the project and the partnership had legitimate and substantial business reasons to appeal the foreclosure litigation.

C. *Patrick G. & Valerie V. O'Malley v. Commissioner* (April 3, 2007) T.C. Memo. 2007-79.

While this case involved reporting penalties, the Tax Court confirmed that IRC Section 108(e)(5) governing purchase-money debt transactions cannot be used to cleanup a sale transaction wherein payment is made to the buyer by the seller and not to the lender. Failure to argue *Fulton Gold* here can be fatal. In this transaction, the court found that a purported joint venture was merely a sale of a house lot and house to a family member – repayment by seller of $54,000 and not classified under IRC Section 108(e)(5) as a purchase price reduction.

While IRC Section 108(e)(5) applies when the debt of a purchaser to a seller is reduced, a payment from the taxpayers to the purchaser represented a debt owed by the taxpayers/sellers to the purchaser. Therefore, the payment did not qualify as a purchase price reduction under IRC Section 108(e)(5).

D. *Johnson v. Commissioner* (1999) 77 TCM 2005, aff'd, 211 F.3d 1265, 86 AFTR2d 2000-6029, 2000-1 USTC ¶ 50,391 (4th Cir 2000).

This decision confirmed the mechanical application of the rule for exclusion of cancelled unpaid interest expenses. Taxpayer took out a mortgage to purchase his residence. After he defaulted, the lender foreclosed on the property, which was sold by the county sheriff for $93,251. At the time of the foreclosure, taxpayer owed the lender $160,014 ($129,292 in mortgage principal and $23,489 in accrued interest). The lender, therefore, sent taxpayer a Form 1099-C, Cancellation of Debt, indicating that he had received $66,763 ($160,014 - $93,251) in discharge of indebtedness income.

While Section 108 provides exceptions to the general rule taxing discharge of indebtedness income if the discharge occurs in a bankruptcy or when the taxpayer is insolvent, in this case, taxpayer did not qualify. IRC Section 108(e)(2), however, also contains an exception if payment of a debt would be deductible by the taxpayer. Thus, the court held that only $31,525 of the $55,014 discharged debt was taxable.

E. *Alpert v. US*, 481 F.3d 404 (6th Cir. 2007).

Taxpayers were a married couple owning stock in an S corporation The corporation became insolvent in 1992, incurring a loss of $7.5M. However, because Taxpayers' basis in the stock was only $3.4M, the excess loss was suspended until the corporation had additional income. The corporation defaulted on a $4.7M loan in 1992. A petition for involuntary bankruptcy was filed against corporation in 1993. By July 1994, the receiver had collected less than $2.9M from the corporation's assets. The Trustee collected another $433,000 in 1994, and another $25,000 in 1995, filing his final report on June 2, 1995. The Trustee filed the final accounting with the Bankruptcy Court in 1996, and the Bankruptcy Court closed the case. Over $31M of unsecured debt was not repaid.

Taxpayers filed a claim for refund for 1991, claiming that they had CODI in 1992, 1993, or 1994, which allowed them to recognize the suspended loss, which they attempted to carry back to 1991.

Stating the applicable standard for determining CODI is whether (i) there is no reasonable possibility that the debt will be repaid; and (2) there was an "identifiable event" fixing the loss with certainty, the *Alpert* court rejected Taxpayers' arguments that the filing of the receiver's report and the "substantial completion" of the bankruptcy case were identifiable events. The court admitted that, while book entries can constitute a financial act resulting in the discharge of debt and that the corporation may have had such a book entry, it refused to recognize such entries in the case at hand because the evidence of such entries produced at trial was inadmissible. HELD, trial court's decision that CODI was received in 1996 was affirmed. Taxpayers could not carry the suspended losses back to 1991.

F. *In re: Higgins*, 2008-1 US Tax Cas. (CCH) 50,220 (Bankr. 2008).

This case illustrates the importance of substantiating financial information in court. The court held that:

1. The debtors did not show by clear and convincing evidence that the FMV of certain foreclosed real property secured by mortgage was greater than the sale price such that no CODI arose as a result of the foreclosure; and

2. Despite the court's statement that there was "no doubt that the debtors were insolvent," because evidence was not introduced to enable the court to determine the extent of the insolvency, it could not determine the extent of the insolvency exception under Section 108, and all CODI had to be recognized.

G. *Keith v. Comr.*, T.C. Summ. Op. 2007-214.

Bank foreclosed on Taxpayers' home mortgage. The value of the house was $90,000 and the mortgage debt was $112,000. Immediately before the foreclosure, Taxpayers had total assets of $133,700 and liabilities of $155,500. IRS argued that for the insolvency exception to apply, the taxpayer must be insolvent both before and after the cancellation of debt. The *Keith* court stated that the taxpayers' insolvency after the cancellation "is, simply put, not relevant." The IRS based its argument on a case superseded by enactment of Section 108(a)(1)(B) (the insolvency exception). Accordingly, notwithstanding $22,000 of cancelled debt, Taxpayers only had to recognize $244 of CODI, the amount by which the cancelled debt exceeded Taxpayers' insolvency.

H. *Stevens v. Comr.*, T.C. Summ. Op. 2008-61.

This case illustrates how CODI and capital gain/loss rules interplay in the disposition of investment real property. Taxpayers purchased the property for $256,000, all of which was financed by a loan secured by the property. The debt was recourse. The property was subsequently sold in a short sale for $200,000, $181,000 of which was paid to the lender in satisfaction of Taxpayers' debt. Although the taxpayers realized $256,000 ($181,000 sales price plus $75,000 of cancelled debt), Regs. § 1001-2 provides that, in such a case, the amount realized is reduced by CODI. As a result, only $181,000 was realized on the exchange, which the court stated resulted in no loss on the sale (presumably because the property had been depreciated from its original $256,000 basis, although the court did not make any indication why it so concluded). In addition the $75,000 of cancelled debt had to be realized as ordinary income, rather than capital gains, pursuant to section 61(a)(12).

I. *Quartemont v. Comr.* , T.C. Summ. Op. 2007-19.

Taxpayers had $77,000 of CODI from credit card debt absolved by the lenders. Though taxpayers considered bankruptcy, they opted to negotiate with the credit card companies directly. Taxpayers argued that they were insolvent. Their basis for this claim was that property that would be exempt from creditors' claims under state law in bankruptcy should be excluded from inclusion in the value of the assets for purposes of the insolvency exception. Taxpayers had equity of approximately $150,000 in their house—if the house and liabilities secured by it were included in the insolvency calculation, then taxpayers would not have been insolvent, but if the house and liabilities secured by it were excluded in the insolvency calculation, then the taxpayers would have been insolvent.

The *Quartemont* court held that assets includes assets exempt from the claims of creditors under state law. The court did not find its conclusion at odds with the bankruptcy exception under section 108(a)(1)(A) because, as the court saw it, the bankruptcy exception was designed to give debtors a "fresh start", consistent with the overall intent of the Bankruptcy Code. The court also noted that such an exception would provide inconsistent results as bankruptcy exclusions vary from state to state.

APPENDIX

FORECLOSURE V. SHORT SALE

Example: In certain cases, a foreclosure may be preferable to a short sale because it results in a better tax position.

Assume that an individual taxpayer purchases a personal residence for $240,000. When the taxpayer is in default, the debt is (still) $200,000, and the property is only worth $170,000, it is (i) sold in a short sale; or (ii) foreclosed upon.

1. **Short Sale**. Under Revenue Ruling 91-31, when the bank reduces the debt from $200,000 to $170,000 in the short sale, there is $30,000 of CODI. Unless there is an insolvency, a bankruptcy or another exemption available under IRC § 108, this CODI must be reported by the taxpayer. Unfortunately, taxpayer's sale of the property for $170,000 will result in a nondeductible personal loss of $70,000.

***Result*:** $30,000 of CODI with no offset for the $70,000 personal loss.

2. **Foreclosure**. Had there been a foreclosure, there would have been no CODI—no taxable income (because it is treated as a purchase price reduction (i.e., a basis adjustment)).

***Result*:** $70,000 personal loss, but no CODI.

Note that, following *Fulton Gold*, no CODI would be reported—the cancellation of debt reduction would be treated as a reduction to the basis of the underlying property--essentially the same result as a foreclosure.