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Cancellation of Debt: Conformity, Short Sales, and More

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CANCELLATION OF DEBT: CONFORMITY, SHORT SALES, AND MORE

Course objectives: The purpose of this course is to provide a discussion of cancellation of debt. Topics discussed include: discharge of debt, recourse and nonrecourse debt, foreclosures and short sales, exclusion from income — IRS §108, reduction of tax attributes, property converted from personal to business use, or vice versa, using IRC §121 in a foreclosure, reporting the COD, and COD income from flow-through entities.

After completing this course, you will be able to:

- Determine the concept and characteristics of discharge of debt
- Identify the provisions in IRC §108 that allow a taxpayer to exclude COD income
- Identify characteristics of an exclusion for cancellation of student loans
- Recall exclusions involving bankruptcy, insolvency, or farm indebtedness provisions
- Determine calculations regarding gain or loss when a nonrecourse debt is cancelled in a foreclosure or short sale
- Identify exclusions of COD income under IRC §108(a) for a partner

Category: Taxes

Recommended CPE Hours: CPAs/PAs — 2 Tax
EAs/CRTPs — 2 Federal Tax

Level: Basic

Prerequisite: None

Advanced Preparation: None

Expiration Date: May 2016*

*Exams must be completed within one year from the date of purchase

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CANCELLATION OF DEBT: CONFORMITY, SHORT SALES, AND MORE

WHAT IS DISCHARGE OF DEBT?

The Internal Revenue Code treats the discharge of indebtedness as income. (IRC §61(a)(12)) The reason is this: When a taxpayer borrows money untaxed and doesn't have to pay it all back, there is an economic benefit that resembles other income.

Although there is no definition of cancellation of debt (COD) income in the Code or regulations, it is firmly established that a taxpayer may realize income from discharge of indebtedness. (IRC §61(a)(12); Treas. Regs. §1.61-12(a); ***U.S. v. Kirby Lumber Co.*** (1931) 284 U.S. 1)

Discharge of debt occurs when a taxpayer is released from indebtedness in whole or in part. A debt may be discharged when:

- A taxpayer buys back the debt for less than the face amount;
- A creditor and debtor agree to settle the debt for less than the full amount owed;
- A creditor simply cancels/discharges the total debt;
- Debt is discharged in bankruptcy;
- The state statute of limitations expires; or
- A lender forecloses on the property.

Practice Pointer

A debt is considered discharged or canceled at the moment it becomes clear that the debt will never have to be repaid based on the likelihood of payment or the worthlessness of the debt. To look at it another way, a debt is not considered discharged as long as there is a reasonable prospect that payment will occur. (IRC §108(e)(2))

The amount of debt forgiven does not include any amount forgiven that would have given rise to a deduction. Thus, in the case of a cash-basis taxpayer with a loan with negative amortization or accrued but unpaid interest, the amount of unpaid interest is not treated as an amount forgiven (and cannot be taken as a deduction). In the case of an accrual-basis taxpayer that previously deducted the interest or a portion of it, the amount previously deducted must be included in income in the year of discharge. (IRS Publication 525)

Example of unpaid interest

George bought real property with a $500,000 mortgage and was paying interest only. When the property value dropped to $400,000, George stopped making payments until the bank foreclosed and took the house. At the time that the bank foreclosed on the house, George owed $500,000 in principal and $75,000 in unpaid interest.

George's debt forgiveness is $100,000 ($500,000 - $400,000). The interest is not part of the forgiven debt and he may not deduct the $75,000 as an interest expense.

DELINQUENT CLIENT FEES

The Office of Professional Responsibility released a response to a practitioner question about issuing Form 1099-C for delinquent client fees. (OPR Issue No. 2015-02 “Practitioners’ use of Form 1099-C (Cancellation of Debt),” www.irs.gov/pub/irs-utl/QA_-_-_Form_1099-C_checked_2.pdf) The notice reminds practitioners of two things:

1. Form 1099-C must not be filed unless there is a legitimate discharge of debt, meaning that someone had an obligation to repay and was released from that obligation; and
2. Only applicable entities may file a Form 1099-C (but see “Taxpayer pulls it off” below).

Debt requirement

The practitioner’s question asked about the implications of using Form 1099-C as an alternative to traditional debt collection techniques for clients who failed to pay for their tax preparation and representation services. The explanation was: “The goal would be to encourage the client to pay, or make him/her report additional income for our ‘free’ services.”

Form 1099-C must only be issued where there has been a discharge of debt — that is, the client no longer has an obligation to repay a sum of money previously received. The discharge of debt must be the result of an “identifiable event” as described in Treas. Regs. §1.6050P-1. The events are listed in the regulation, and include legal events such as bankruptcy, foreclosure, statute of limitations on claims, etc.

However, one event listed involves the decision of the creditor to discontinue collection activity and discharge the debt. This may occur as part of a defined policy such as a written company policy or an established business practice that discharges a debt after the end of a certain period of nonpayment. (See Treas. Regs. §1.6050P-1(a)(1))

Regarding the practitioner question addressed in the notice, the difference lies in the practitioner here admitting to using Form 1099-C as a debt collection tool, rather than to report a discharge of a legitimate debt.

Applicable entities

IRC §6050P establishes the requirement to file an information return reporting a discharge of debt. However, it is directed only at “applicable entities” and excludes from such reporting any discharge below $600. An applicable entity is defined as:

- An executive, judicial, or legislative agency of the United States; or
- An applicable financial entity, such as a bank, savings and loan association, credit union, the FDIC, or any organization a significant trade or business of which is the lending of money. (IRC §6050P(c))

A tax practitioner will most likely not fall into one of these categories.

Circular 230

The OPR notice makes a point of stating that using Form 1099-C as a debt collection instrument is in disregard of the requirement that an identifiable event occurred, and calls into question the fitness of the practitioner to practice before the IRS under several sections of Circular 230, namely:

- Due diligence in preparing correct documents related to IRS matters (§10.22(a));
- Competence, as related to understanding the filing requirements for Form 1099-C (§10.35); and
- Disreputable conduct, as related to filing misleading information with the Department of the Treasury. (§10.51(a)(4))

At the end of the notice, however, OPR notes that Circular 230 violations are examined on a case-by-case basis. If they were to examine this situation, the case would hinge on whether the client had "received previously untaxed funds from an applicable entity for which there is an obligation for repayment."

Possible monetary consequences

Aside from consequences relating to Circular 230 and fitness to practice, there could be civil penalties that result from issuing Form 1099 unnecessarily.

An individual was awarded damages for costs sustained due to the fact that the defendant filed a false Form 1099 in his name. (***Shiner v. Turnoy*** (August 11, 2014) U.S. District Court, Northern District of Illinois, Case No. 13 C 5867) The individuals involved were insurance agents who agreed to share insurance commissions. They entered into a dispute about the amount owing, so one agent sent the other a check for less than the amount in dispute but put language on the check that any endorsement constituted full payment and release. The payee never deposited or cashed the check, but the payor issued him a 1099 anyway.

The payee brought suit under IRC §7434, which provides that "If any person willfully files a fraudulent information return with respect to payments purported to be made to any other person, such other person may bring a civil action for damages against the person so filing." Under IRC §7434(b), the amount of the damages is equal to the greater of $5,000 or the sum of actual damages, costs of the action, and attorney fees.

The court noted that when one places a restrictive endorsement on a check, it imposes a condition upon its acceptance and gives the creditor a legal right to reject the condition by refusing the check. In such situations, receiving a check with a restrictive endorsement does not constitute constructive receipt, and no payment will be considered as having been made unless and until the check is actually accepted. Reviewing damages, including costs of dealing with the IRS and reasonable attorney fees, the court awarded the plaintiff $16,314.90.

In another case, the founding partner of an accountancy firm was held liable for damages under IRC §7434 after he issued Forms 1099 to antagonize two partners who left the firm. (***Pitcher v. Waldman*** (January 15, 2015) U.S. Court of Appeals, Sixth District, Case Nos. 14-3369, 14-3392) The two partners received a settlement that allowed them to take their clients' accounts and some accounts receivables with them and also required the firm to pay the two partners' legal fees. The founding partner willfully mischaracterized these payments and filed fraudulent Forms 1099, and sent copies to the two partners along with notes that read "you are going to hell." The founding partner was hit with $5,000 in damages for each fraudulent filing.

Taxpayer pulls it off

A taxpayer was successful in issuing a Form 1099-C to her ex-son-in-law after he failed to pay her back for debt he incurred on her credit card. (***Cavoto v. Hayes*** (2011) U.S. Court of Appeals for the Seventh District, Case No. 10-2681) Her ex-son-in-law filed suit, claiming that the filing was fraudulent because his ex-mother-in-law was not a financial institution under IRC §6050P(c) and she only filed with the intent to cause him to pay extra tax.

The court rejected the contention that a Form 1099-C filed by someone other than a financial entity is necessarily fraudulent; although the taxpayer was not required to file Form 1099-C, she was not prohibited from doing so. Moreover, the court added, filing a Form 1099-C is not equivalent to filing a false return, so long as the information in the form is accurate.

Because of the oral agreement regarding repayment between the two parties, the taxpayer had a good-faith belief that she was canceling a *bona fide* debt when she filed the Form 1099-C; therefore, the filing was not fraudulent.

DISCHARGED CREDIT CARD DEBT

A taxpayer was liable for tax on unreported income from discharged credit card debt. The taxpayer argued that cancellation of credit card debt is nontaxable because it was unsecured and only partially discharged. (***Appeal of Chapi***n (September 23, 2014) Cal. St. Bd. of Equal., Case No. 732938) Under IRC §61(a)(12), unsecured credit card debt such as this can produce debt relief income. Under Treas. Regs. §1.61-12, "the discharge of indebtedness, in whole or in part, may result in the realization of income."

NO COD INCOME FROM UNPAID LOAN

The Tax Court held that when a debt is fully secured by collateral that exceeds the loan balance, default alone does not result in COD income. (***Pinn v. Comm.***, TCM 2013-45)

✐ Practice Pointer

A debtor's declaration of bankruptcy is not, by itself, evidence that a debt is worthless, but is only an element to be considered for purposes of determining the value of the debt. Even a bankrupt debtor may be able to pay off some of the debt.

The *Pinn* case

The Pinns failed to repay plan loans they took out from their construction firm's welfare benefits fund. However, under the terms of the plan, the loans could be repaid either in installments or from death benefits that would otherwise go to the borrower's beneficiaries.

The IRS argued that, because the Pinns never made any payments on the loans, they were in default and should be charged with COD income. The Tax Court held that because the Pinns' death benefits exceeded their debts, they were not in default under the loan agreement.

The court did state that the mere existence of collateral isn't what prevented the taxpayers from having COD income; it was the fact that the collateral was sufficient to satisfy the full amount of the debt.

Contingency of the death benefits

The IRS also argued that, because the Pinns' death benefits were contingent, they weren't sufficient to be a valid form of collateral. The court agreed that it was possible that at some point the plan would terminate without having to pay any death benefits.

The court also noted that this had not happened as of the tax years at issue. The decision stated that if and when the Pinns lost their death benefits, the usefulness of those benefits as collateral for the loan would disappear. But that hadn't happened in the year in question, so there was no COD income.

DEBT ASSUMED IN DIVORCE

A taxpayer received cancellation of debt income from a loan that was assumed by his ex-wife pursuant to their divorce decree. (***Jensen v. Comm.***, TCM 2010-77)

Although the decree stated that the ex-wife was responsible for the debt in question, and that the husband had indemnification rights against the ex-wife for the debts and any costs associated with them, the husband was not relieved of liability by the lender. Because the husband was liable to the bank for the debt, he incurred COD income when the debt was canceled.

Caution

Many divorcing taxpayers are having trouble refinancing homes that are underwater. Because the loans can't be refinanced, this is a problem that your clients could encounter if they remain liable for a debt, even though the divorce decree says the ex-spouse must make the payments.

MILITARY MEMBERS — MOTOR VEHICLE LEASES

If a member of the military enters into a vehicle lease and is later deployed for a period of not less than 180 days, he or she may terminate the lease without recognizing income. (§305(a) of the Servicemembers Civil Relief Act) The lessor is also prohibited from charging an early termination fee.

Because the servicemember owes nothing and doesn't have any discharge of indebtedness income, the lessor should not issue a Form 1099-C.

DISCHARGED LOAN TO EMPLOYEE IS COD, NOT COMPENSATION

An employee who received loans from his former employer that were discharged received COD income rather than compensation. (***McAllister v. Comm.***, TCM 2013-96) In addition, a portion of the COD income was excludable under the insolvency provisions of IRC §108.

Facts of the case

John McAllister was an employee of Suncoast Roofers Supply. During 2005, he borrowed $78,849 from his employer. The parties executed a promissory note that provided, among other terms, the loans would be repaid out of bonuses that McAllister was expected to earn through company incentive plans.

However, McAllister had made no repayments on the loans when Suncoast ran into financial difficulties. In 2007, the company was sold, and McAllister was no longer employed by the company.

McAllister timely filed his 2007 tax return in March 2008. In May 2008, the new owners issued him a Form 1099-MISC, characterizing the discharged loan balance as nonemployee compensation for 2007. McAllister did not report the income, and the IRS issued him a notice of deficiency.

The IRS argued that the company had awarded McAllister a constructive bonus that he used to pay off the loans. McAllister took the position that either (1) he still intended to repay the loans; or (2) even if the loans were cancelled, the cancellation did not represent compensation; and (3) he was insolvent.

COD is income, not compensation

The court noted that McAllister credibly testified that Suncoast did not inform him that he was receiving a bonus of $78,849 in 2007. The acquiring company never contacted McAllister about repaying the loan.

Therefore, the court found that the Form 1099-MISC memorialized the acquiring company's intent to forgive the debt. However, the court also found that the Form 1099-MISC improperly classified the forgiven debt as nonemployee compensation; that is, the classification was "a bookkeeping error."

The court then examined McAllister's assets and liabilities as of the time of discharge. It found that his liabilities exceeded his assets by $22,641. Thus, $22,641 of the $78,849 COD income was excludable under the insolvency exception under IRC §108. The $56,208 of remaining income was includible as COD income and not as payment for services.

Comment

Not only was McAllister able to exclude $22,641 from income for income tax purposes, but presumably he was able to avoid having the entire $78,849 subject to self-employment tax.

RECOURSE AND NONRECOURSE DEBT

If the mortgaged loan is recourse, the lender *has recourse* to assets of the borrower other than solely the assets securing the loan. If the loan is nonrecourse, it doesn't mean the loan is unsecured, it means the lender only has claim to the assets securing the debt.

SO, IS THE LOAN RECOURSE OR NONRECOURSE?

A loan is an obligation to pay and must be paid in full. As such, the default answer is that a loan is recourse unless made nonrecourse in one of two ways:

- By specific terms of the loan making it nonrecourse; or
- By operation of law.

California law specifically prohibits recovery of a deficiency from a borrower who incurred the loan in order to purchase real property as a residence for the debtor when the property contains one to four units and the property was used to secure the purchase loan. (Code of Civil Procedure §580b)

Accordingly, an original loan to purchase a principal residence in California is, by California law, nonrecourse. However, a refinanced loan is very likely recourse unless the terms of the loan make it nonrecourse.

THE TWO-STEP APPROACH TO RECOURSE DEBT

If property subject to a recourse debt is conveyed to a creditor, the transaction is split into two parts:

1. A taxable disposition of the property; and
2. Either a continuing debt obligation owed to the creditor or a discharge of the remainder of the liability, to the extent that the value of the property is less than the recourse liability.

Under this approach, the taxpayer recognizes gain or loss equal to the difference between the FMV of the property and the taxpayer's adjusted tax basis immediately prior to the disposition. If the remainder of the debt is forgiven, the amount forgiven will constitute COD income which, unless excluded under IRC §108, will be included in the taxpayer's ordinary gross income.

When the taxpayer is personally liable for the debt (recourse debt), the lender can go after (has recourse to) the taxpayer's other assets if the FMV of the property taken back is less than the outstanding loan amount. To the extent that the lender releases the borrower from further liability, the borrower will have COD income. (Treas. Regs. §1.1002-2(a)(2); Rev. Rul. 90-16; ***Bressi v. Comm.***, TCM 1991- 651, aff'd. *per curiam* (1993) 989 F.2d 486; ***James J. Gehl, et ux.*** (1994) 102 TC 784, aff'd. 50 F.3d 12)

If the property is encumbered by recourse debt, the taxpayer is required to make two calculations when the property is foreclosed:

- To the extent that the FMV of the property exceeds the basis, gain or loss on the disposition of the property results. The FMV is treated as the sales price of the property; and
- To the extent that the indebtedness exceeds the FMV of the property, COD income results. In a foreclosure, the FMV of the property is usually less than the debt forgiven.

Example of foreclosure on recourse debt
(without regard to any COD exclusion)

Lila Bility owes Budget Bank $300,000 on her principal residence. The loan is recourse. It is qualified principal residence indebtedness. The value of the property has dropped to $275,000 as her ARM adjusted upward, and she can no longer afford the payments. The property's basis is $250,000.

Recourse debt	$300,000
FMV	(275,000)
COD income	$ 25,000
FMV	$275,000
Basis	(250,000)
Gain	$ 25,000

Lila has $25,000 COD income and $25,000 of gain.

The bifurcated approach of recourse debt can produce strange tax circumstances.

Example of recourse debt when basis exceeds FMV
(without regard to any COD exclusion)

Assume that Lila's property has a FMV of $250,000 and a basis of $275,000.

Recourse debt	$300,000
FMV	(250,000)
COD income	$ 50,000
FMV	$250,000
Basis	(275,000)
Gain	$ (25,000)

Lila has $50,000 COD income and $25,000 nondeductible loss on the sale of her personal residence.

THE ONE-STEP SALES APPROACH TO NONRECOURSE DEBT

There is no COD income triggered on the cancellation of a nonrecourse debt, unless you retain the collateral. The only calculation involved when the nonrecourse debt is canceled in a foreclosure or short sale is the amount of possible gain or loss on the "sale."

The amount realized is the greater of:

- The principal amount of the debt; or
- The fair market value of the property.

Thus, if property subject to a nonrecourse debt is conveyed to the creditor and the nonrecourse debt exceeds the FMV of the property, the debtor will recognize gain or loss equal to the difference between the amount of the liability discharged (plus the amount of cash and FMV of any property paid to the debtor) and the debtor's adjusted tax basis in the property immediately before the disposition.

No portion of the debtor's gain is treated as COD income. Further, the property's FMV is irrelevant to the calculation. (***Comm. v. Tufts*** (1983) 461 U.S. 300)

Example of foreclosure on nonrecourse debt

In the example above, Lila's mortgage is nonrecourse:

Nonrecourse debt	$300,000
Basis	(275,000)
Gain	$ 25,000

The foreclosure is treated entirely as an exchange with gain. There is no COD income on this foreclosure.

If the property qualifies under IRC §121, the gain may be excluded.

Loan modifications

If you are not personally liable for the debt, you do not have COD income unless you keep the property securing the debt and either:

- The lender offers a discount for the early payment of the debt; or
- The lender agrees to a loan modification that results in a reduction of the principal balance of the debt.
  (Rev. Ruling 91-31; Rev. Ruling 92-99)

As a result, in the case of a loan modification, because the taxpayer retains the property, a nonrecourse loan could generate COD income. However, the exceptions discussed below would apply to this COD income.

TWO DEBTS — ONE NONRECOURSE, ONE RECOURSE

It is common for taxpayers to have more than one debt securing the residence. In many instances, the first mortgage is nonrecourse and the second mortgage (perhaps a line-of-credit loan) is recourse. How do you figure the COD income and gain/loss on foreclosure when you encounter this situation?

Because one of the loans is a recourse loan, you must use the two-step approach discussed above, which means that the COD income is equal to the difference between the amount of the debt and the FMV of the property. But you have two loans, not one, and only part of the FMV of the property is allocable to the recourse debt. How do you solve this problem?

You must allocate the FMV of the residence to the particular loans in order to find out how much COD income is attributable to the recourse debt. The FMV is allocated to the debts in the order of their legal priority.

Example of foreclosure where one debt is nonrecourse and one debt is recourse (without regard to any COD exclusion)

Lila Bility has two loans on her principal residence with Budget Bank: a $200,000 nonrecourse first incurred when she purchased the property, and a $100,000 recourse second loan she used to pay off credit cards.

The value of the property has dropped to $275,000 and she can no longer afford the payments. The property's basis is $250,000.

Total debt	$300,000
FMV	(275,000)
Debt forgiveness	$ 25,000

The FMV of the property must be allocated to the two debts to determine the amount of COD income. The solution is to allocate the FMV of the property to the two debts in order of their legal priorities (i.e., allocated to the $200,000 original nonrecourse debt and then to the $100,000 recourse debt, because the $200,000 debt would normally be paid off first).

Nonrecourse debt	$200,000
FMV allocated to nonrecourse debt	(200,000))
Balance	$ 0
Recourse debt	$100,000
FMV allocated to recourse debt	(75,000)
COD income	$ 25,000
FMV	$275,000
Basis	(250,000)
Gain	$ 25,000

Lila has $25,000 COD income and $25,000 of gain.

FORECLOSURES AND SHORT SALES

Foreclosure is an equitable proceeding in which a bank or other secured creditor sells or repossesses a secured asset due to the owner's failure to comply with the terms of the loan agreement or mortgage.

Short sales are becoming more common. In a short sale, the lender and creditor agree to let a third party purchase the property for less than the loan balance, and the lender agrees to cancel the balance of the debt. This may be a "win-win" situation. The borrower avoids having a foreclosure on his or her credit record, and the lender avoids the costs of foreclosure.

Example of a short sale

Fred's house has a fair market value of $450,000 and his mortgage stands at $550,000. Fred finds a buyer willing to pay $450,000 and the bank agrees to the short sale in satisfaction of the $550,000 mortgage balance. Fred avoids a foreclosure going on his credit report and the bank avoids the cost of foreclosure.

IRS POSITION ON CALIFORNIA SHORT SALES

The IRS has stated that "non-purchase-money loans subject to California's anti-deficiency statutes generally appear to be recourse loans from their inception. We were overly broad in our prior response in extending our analysis of the federal tax treatment of obligations beyond those described in §580b(a)(3)."

In short, the IRS is saying that, for tax purposes, a recourse note does **not** become nonrecourse because the bank agreed to a short sale.

2011 California law changes

In 2011, California enacted an anti-deficiency provision, which generally prohibits a lender who holds a deed of trust on a homeowner's principal residence from either claiming a deficiency or obtaining a deficiency judgment from the homeowner after agreeing to a short sale.

Pursuant to Cal. Code of Civ. Proc. §580e, for short sales occurring between January 1, 2011, and June 30, 2011, only the first trust deed is converted to nonrecourse debt. Beginning July 1, 2011, first and second trust deeds are converted to nonrecourse debt.

The statute effectively limits the homeowner's liability to the amount the lender received on the sale of the principal residence, and the homeowner is not personally liable for the deficiency balance (the difference between the loan balance and the sales price).

The September 13, 2013, IRS letter stated that the IRS believed that a homeowner's obligation under the anti-deficiency provision of Code of Civ. Proc. §580e would be a nonrecourse obligation to the extent that, for federal income tax purposes, the homeowner will not have COD income. Instead, the homeowner must include the full amount of the nonrecourse indebtedness in the amount realized.

At that time, the IRS opined that if the debt is considered to be a nonrecourse debt, the taxpayer will report the transaction as a sale rather than as COD and a sale. In many cases, this will result in the taxpayer being able to exclude the gain under IRC §121.

The IRS then issued a follow-up letter stating that they were reconsidering their position. (Information Letter 2014-0002 (March 28, 2014))

California conformity

Because California conforms to IRC §108, with certain unrelated exceptions, California conforms to the IRS letters.

You can find all the letters at:

Website
www.caltax.com/spidellweb/public/editorial/ShortSaleLetters.pdf

CALIFORNIA LAW PROTECTS TAXPAYERS WHO REFINANCE ACQUISITION DEBT

Beginning January 1, 2013, when a borrower refinances a purchase money nonrecourse loan, the lender cannot receive a deficiency judgment on the refinanced loan. (SB 1069 (Ch. 12-64); Code of Civ. Proc. §580b) This protects borrowers who are simply refinancing their original loans for better interest rates, etc. However, if the borrower borrows any additional funds that are not applied to the obligations under the original loan, or for fees or costs related to the expenses of the refinance, the bank can come after them for any shortfall on the additional debt.

If the taxpayer borrows additional funds, all future payments are credited to the original principal first.

Example of refinanced loan

Betty borrows $450,000 to purchase her home in 2010. In 2014, Betty refinances her loan to take advantage of a lower interest rate.

Betty does not borrow any additional money. She simply refinances the amounts owed on her original loan, plus the costs of the refinance.

We have not seen any specific guidance on this law from the IRS.

In April, the IRS issued a letter addressing the California law that protects taxpayers in certain short sales from deficiency judgments. The IRS letter stated that the protection from a deficiency judgment did not change the nature of the debt.

In other words, although the bank couldn't go after the taxpayer, a cancelled recourse loan would still generate COD income. It is unclear what that analysis means for taxpayers with these refinanced loans, but we may still have to look to the terms of the loan to determine if it is recourse or nonrecourse for COD purposes.

EXCLUSION FROM INCOME — IRC §108

Income from forgiveness of debt is taxable under IRC §61. However, IRC §108 contains provisions that allow a taxpayer to exclude COD income in certain cases, for example:

- A discharge of a debtor in a bankruptcy proceeding;
- A discharge of an insolvent taxpayer;
- A discharge of qualified farm indebtedness;
- A qualified student loan discharge;
- Discharge of debt in exchange for services; or
- Qualified real property business indebtedness.
  (IRC §108(i))

In order of precedence, the bankruptcy exclusion comes first, followed by the insolvency exclusion. (IRC §108(a)(2)(A)) However, the §108(h)(1) exclusion for qualified principal residence indebtedness takes precedence over the insolvency exclusion, unless the taxpayer elects to apply the insolvency exclusion. The exclusion regarding bankruptcies takes precedence over all other provisions of IRC §108, including the principal residence exclusion.

CALIFORNIA CONFORMITY

California conforms to most of the federal COD provisions found in IRC §108, including:

- Bankruptcy;
- Insolvency; and
- Business real property indebtedness.

California partially conformed to the principal residence exclusion for taxable years beginning on or after January 1, 2009, and before January 1, 2014. California's principal residence exclusion has not yet been extended to 2014. See below for more information.

THE BANKRUPTCY EXCLUSION

No amount is included in a taxpayer's gross income by reason of a discharge of indebtedness (in whole or in part) in a bankruptcy proceeding.

Specific tax attributes of the bankrupt taxpayer must be reduced by the amount excluded from income under the bankruptcy provisions, unless the taxpayer elects to apply all or any portion of the excluded amount first to reduce his basis in depreciable assets (discussed later).

The bankruptcy exclusion applies even if the taxpayer is solvent after the discharge. Any amount of discharge of indebtedness that exceeds the amount by which tax attributes are reduced under this rule is disregarded. The excess is not included in income and has no other tax consequences.

The bankruptcy exclusion only applies if the debt is discharged in the bankruptcy. It would not apply if the bank forecloses on the property and the taxpayer, not the bankruptcy estate, owns the property.

California conformity

California fully conforms to this provision.

THE QUALIFIED PRINCIPAL RESIDENCE EXCLUSION

The Tax Increase Prevention Act of 2014 extended the cancellation of debt (COD) exclusion for principal residences through 2014.

Under IRC §108(a)(1)(E) and (h), a taxpayer may exclude from income up to $2 million of COD income from the discharge of qualified principal residence acquisition indebtedness on or after January 1, 2007, and before January 1, 2015. (IRC §108(a)(1)(E) and (h))

Qualified principal residence indebtedness is acquisition debt as defined in IRC §163(h)(3)(B), but with a $2 million limit ($1 million for married filing separately). (IRC §108(a)(1)(E) and IRC §108(h))

It does not include home equity indebtedness for which mortgage interest may be allowable as a deduction under IRC §163(h)(3)(C). "Principal residence" has the same meaning as under the home sale exclusion rules of IRC §121.

✐ **Practice Pointer**

"Qualified principal residence indebtedness" as defined under IRC §108(h)(2) is the same as "acquisition indebtedness" as defined under IRC §163(h)(3)(B), with two important differences:

- Qualified principal residence indebtedness is limited to $2 million (or $1 million on a separate return), whereas acquisition indebtedness for purposes of the mortgage interest deduction is limited to $1 million (or $500,000 on a separate return); and
- Qualified principal residence indebtedness applies solely to a taxpayer's principal residence, and not a second home. For purposes of the mortgage interest deduction, acquisition indebtedness can be incurred with respect to a taxpayer's principal residence plus one other residence, such as a vacation home.

When a portion of the mortgage is not qualified principal residence indebtedness

As mentioned above, only COD income attributable to acquisition indebtedness may be excluded under the principal residence exclusion. What happens when only a portion of the debt (such as the amount that exceeds the $2 million statutory limit), or a separate debt (such as a home equity debt or a refinanced loan whose proceeds weren't used for qualified purposes) is canceled along with acquisition indebtedness? IRC §108(h)(4) provides for an "ordering rule."

Under this ordering rule, if only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged that exceeds the portion of the debt that is not qualified principal residence indebtedness. (IRC §108(h)(4)) Effectively, then, the portion that is not qualified principal residence indebtedness is treated under IRC §108 as having been discharged first.

Example of nonexcludable debt

Mr. and Mrs. Casey purchased a personal residence for $470,000, paying $40,000 down and obtaining a nonrecourse mortgage loan of $430,000.

When the FMV of the residence had risen to $550,000, and the principal balance of the original mortgage loan was $420,000, they refinanced the first mortgage loan for $430,000 and took out a home equity line-of-credit (HELOC) from the same lender for $70,000.

Both loans were recourse. The Caseys used the proceeds of the loans to purchase a boat.

When the FMV of the residence was $380,000, the lender foreclosed on the property and canceled the remaining debts. At that time, the principal amounts owed on the two loans were $425,000 and $65,000.

Of the $425,000 balance owed on the refinanced loan, $5,000 does not qualify as principal residence indebtedness because IRC §163(h)(3)(B) provides that refinancing indebtedness ($425,000) qualifies as acquisition indebtedness, but only to the extent that it doesn't exceed the principal balance of the debt paid off by the refinanced loan ($420,000). Also, none of the $65,000 balance owed on the HELOC loan qualifies as acquisition indebtedness because the proceeds were used to purchase a boat.

The Casey's COD income is calculated as follows:

Recourse debt ($425,000 + $65,000)	$490,000
FMV	(380,000)
COD income	$110,000
Less: Nonqualified debt	(70,000)
COD income eligible for principal residence exclusion	$ 40,000

The Caseys may only exclude $40,000 of this COD income under the principal residence exclusion, and they will have $70,000 of COD income not eligible for the exclusion, unless they qualify for insolvency.

No exclusion for home equity loan used to buy another residence

Taxpayers were denied use of the $2 million exclusion of cancellation of debt income because the home equity loan they had taken was used to purchase a second residence. (***Koriakos v. Comm.***, TCS 2014-70) The taxpayer's first residence was in Arizona, and they took a home equity loan to purchase another home in Florida. They abandoned the Arizona home, and it was foreclosed upon and sold at auction. The taxpayers tried to claim the $2 million exclusion of cancellation of debt income (IRC §§108, 163(h)(3)(B)(i)); however, the exclusion is only available for debt that is used to acquire or improve the same residence.

CALIFORNIA'S PRINCIPAL RESIDENCE EXCLUSION

California's COD principal residence exclusion expired on December 31, 2013.

At this point the exclusion has not been extended to 2014. The California Assembly is holding off any vote on a COD conformity bill, AB 99, which, if enacted, will retroactively extend the exclusion for qualified principal residence debt through December 31, 2014, and abate any associated penalties and interest.

If the exclusion is not extended, a taxpayer must look to insolvency to exclude COD income on a principal residence.

For taxable years beginning on or after January 1, 2009, and before January 1, 2014, California conforms to IRC §108(a)(1)(E) and §108(h)(2) with these major exceptions:

- Qualified principal residence indebtedness is limited to $800,000 ($400,000 for married filing separate) instead of the federal $2 million ($1 million for married filing separate); and
- The maximum COD exclusion is further limited to $500,000 ($250,000 for taxpayers married filing separate).
  (R&TC §17144.5)

Example of principal residence exclusion for federal but not California

In 2014, the bank foreclosed on Jim's principal residence. The property had:

Outstanding recourse debt	$800,000
FMV	(600,000)
COD income	$200,000

For federal purposes, he may exclude the COD of $200,000 using the principal residence exclusion. For California purposes (unless the California Legislature retroactively conforms), he has COD of $200,000. He must use insolvency to exclude the debt for California purposes.

THE INSOLVENCY EXCLUSION

A taxpayer may exclude from income a discharge of indebtedness that occurs while the taxpayer is insolvent (but not involved in bankruptcy proceedings) up to the amount by which he or she is insolvent. (IRC §108(a)(1)(B), (a)(2)(A), and (a)(3))

The excluded amount is applied to reduce tax attributes in the same manner as if the discharge had occurred in a bankruptcy proceeding. And, as with the bankruptcy exclusions, an insolvent taxpayer may elect to apply all or a portion of the excluded amount first to reduce his basis in depreciable assets or in real property held as inventory, rather than to reduce the tax attributes.

✐ Practice Pointer

If the taxpayer has no tax attributes, COD still applies.

The amount of any discharge of indebtedness in excess of the amount by which the taxpayer is insolvent is treated in the same manner as the discharge of the indebtedness of a wholly solvent taxpayer, and thus will generally be included in income. (IRC §§61(a)(12), 108(a)(3))

When is a taxpayer insolvent?

The term "insolvent" means that there is an excess of liabilities over the FMV of assets, determined on the basis of the taxpayer's assets and liabilities immediately before the discharge. (IRC §108(d)(3)) Assets for this purpose include assets that are exempt from creditors' claims under state law. (***Carlson v. Comm.*** (2001) 116 TC 87) Liabilities include contingent liabilities or liabilities that the taxpayer has guaranteed if it is more likely than not that the taxpayer will be called upon to pay them. (***Merkel v. Comm***. (1999) 192 F.2d 844) A taxpayer must be able to prove insolvency. (***Rinehart v. Comm.***, TCM 2002-71)

For many taxpayers, especially those who have frequently refinanced their residence, the insolvency provisions will allow them to exclude most of their discharge.

Example of insolvency

Gary bought his house for $200,000. He refinanced the property several times, and used the proceeds to send his kids to college, take vacations, purchase a boat, etc. The value of the house had risen to $700,000, and the balance of his mortgage was $650,000.

All of the debt was recourse debt, and only $150,000 was acquisition indebtedness.

The home's value has fallen to $500,000. He has other assets worth $50,000 and other liabilities of $80,000.

Gary is insolvent to the extent of $180,000 (total assets of $550,000 and total liabilities of $730,000).

Assets for purposes of the insolvency exclusion

For purposes of the insolvency exclusion, the term "insolvent" means the excess of liabilities over the FMV of assets. Insolvency is determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

The Code provides only for "assets." Thus, a taxpayer must count cash, stocks and bonds, and other business and investment assets along with personal assets such as a personal residence, auto, and household goods.

More controversial are exempt assets. Both the IRS and the Tax Court have previously held that assets exempt from creditors' claims are excluded when taking account of a taxpayer's assets in determining insolvency. (***Babin v. Comm.***, TCM 1992-673; ***Hunt v. Comm.***, TCM 1989-335; ***Estate of Marcus v. Comm.***, TCM 1975-9; PLR 9125010) However, these cases were decided under the judicial insolvency exclusion that preceded the statutory exclusion.

More recently, both the Tax Court and the IRS have ruled the opposite way; that is, they have ruled that assets exempt from creditors are counted (***Carlson v. Comm.*** (2001) 116 TC 87; PLR 199932013; TAM 199935002), including pension assets. (SCA 1998-039)

For purposes of valuing pension assets, defined contribution plans are valued as the FMV of the participant's account on the date of discharge.

Defined benefit plans are valued in one of two ways, depending on whether the participant has started receiving benefits:

- **Has started to receive benefits:** Actuarial present value of the payments to be made using the interest rate and mortality tables at Treas. Regs. §20.2031-7; or
- **Has not started receiving benefits:** Greater of the actuarial present value of the accrued benefit payable at normal retirement age, or the amount of any single-sum distribution that the participant could receive under the plan as of the discharge date.

Nonrecourse debt and insolvency

For purposes of computing a taxpayer's insolvency, excess nonrecourse debt ("excess" meaning the amount by which the debt exceeds the property's FMV) is not counted as a liability in determining insolvency except to the extent that the excess nonrecourse debt is discharged. (Rev. Rul. 92-53, 1992-2 C.B. 48)

Excess nonrecourse debt is not taken into consideration in computing insolvency except when discharged because it has no effect on a taxpayer's ability to pay tax (because the lender will never be able to recover any more than the FMV of the property).

Example of nonrecourse debt on insolvency

Variation 1

Assume, in the example on page 16, that Gary's $650,000 mortgage loan was nonrecourse. Also assume that he reached an agreement with his other creditors to settle the $80,000 in liabilities for $20,000.

As a result, he has COD income of $60,000. Immediately before the discharge, Gary is insolvent to the extent of only $30,000 (other assets of $50,000 less other liabilities of $80,000; the excess nonrecourse debt is not included in the computation). As such, he can exclude only $30,000 of the $60,000 of COD income.

Variation 2

Assume, again, that the $650,000 mortgage loan is nonrecourse, but that the lender instead agreed to reduce his mortgage loan to $500,000, the FMV of the property. As such, $150,000 is discharged. Now Gary is insolvent to the extent of $180,000, which is:

- $30,000 — the excess of other liabilities over other assets; plus
- $150,000 — the lesser of the amount of nonrecourse debt discharged ($150,000) or the amount of excess nonrecourse debt (also $150,000).

In this situation, Gary can exclude the entire $150,000 of discharge.

The IRS has ruled that the insolvency exclusion is not available to a taxpayer who transfers property to the lender in exchange for the cancellation of the nonrecourse debt to which the property is subject, because cancellation is included in taxpayer's amount realized in the sale of the property and is not cancellation of indebtedness income. (Rev. Rul. 90-16, 1990-1 C.B. 12; TAM 9302001)

Proper completion of Form 982 required

To make a valid insolvency election, the taxpayer must complete Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), and must list tax attributes, including reducing basis in personal assets.

A taxpayer was given additional time to correct errors in making an insolvency election under IRC §108. (PLR 201408007) In preparing Form 982, the preparer failed to complete the required part of the form to reduce tax attributes and/or basis of other property as required under IRC §1017. The IRS ruled that the mistake could be corrected, and the taxpayer was given additional time to file an amended return and attach a properly completed Form 982.

California conformity

California conforms to the insolvency exclusion. (R&TC §17024.5)

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Which of the following statements is true regarding discharge of debt?
   a) Debts below $1,000 are excluded from the requirement to file an information return reporting a discharge of debt.
   b) The discharge of indebtedness, in whole or in part, may result in the realization of income.
   c) Cancellation of credit card debt is nontaxable.
   d) If any person willfully files a fraudulent information return with respect to payments purported to be made to any other person, that other person may bring a civil action for damages equal to the greater of $2,500 or the sum of actual damages, costs of action, and attorney fees against the person filing.

2. Which of the following is correct as it pertains to recourse and nonrecourse debt?
   a) If a loan is nonrecourse, it is unsecured.
   b) Any loan to purchase or refinance a principal residence in California is, by California law, nonrecourse.
   c) If property is encumbered by recourse debt and is foreclosed, to the extent that the indebtedness exceeds the FMV of the property, COD income results.
   d) There is COD income triggered on the cancellation of a nonrecourse debt.

3. Under IRC §108, the bankruptcy exclusion is characterized by which of the following?
   a) The bankruptcy exclusion applies even if the taxpayer is solvent after the discharge.
   b) No amount is included in a taxpayer's gross income by reason of a discharge of indebtedness (in whole but not in part) in a bankruptcy proceeding.
   c) California partially conforms to the bankruptcy exclusion.
   d) The bankruptcy exclusion would apply even if the bank forecloses on the property and the taxpayer owns the property rather than the bankruptcy estate.

4. Details surrounding the qualified principal residence exclusion include which of the following?
   a) Under IRC §108(a)(1)(E) and (h), a taxpayer may exclude from income up to $2 million of COD income from the discharge of qualified principal residence acquisition indebtedness on or after January 1, 2007, and before January 1, 2016.
   b) Qualified principal residence indebtedness includes home equity indebtedness for which mortgage interest may be allowable as a deduction.
   c) Qualified principal residence indebtedness is the same as acquisition indebtedness.
   d) Qualified principal residence indebtedness applies only to a taxpayer's principal residence.

SOLUTIONS TO REVIEW QUESTIONS

1. Which of the following statements is true regarding discharge of debt? **(Pages 2-4)**

   a) Incorrect – Debts below $600 are excluded from the requirement to file.
   b) Correct – This is true under Treas. Regs. §1.61-12.
   c) Incorrect – Unsecured credit card debt can produce debt relief income.
   d) Incorrect – The amount of damages is equal to the greater of $5,000 or the sum of the damages, costs of action, and attorney fees.

2. Which of the following is correct as it pertains to recourse and nonrecourse debt? **(Pages 6-8)**

   a) Incorrect – If the loan is nonrecourse, it doesn't mean the loan is unsecured, but that the lender only has claim to the assets securing the debt.
   b) Incorrect – A refinanced loan is likely recourse unless the terms of the loan make it nonrecourse.
   c) Correct – This is true under Treas. Regs. §1.1002.
   d) Incorrect – There is no COD income triggered unless the collateral is retained.

3. Under IRC §108, the bankruptcy exclusion is characterized by which of the following? **(Page 12)**

   a) Correct – Any amount of discharge of indebtedness that exceeds the amount by which tax attributes are reduced under this rule is disregarded.
   b) Incorrect – This is true whether the discharge is in whole or in part.
   c) Incorrect – California fully conforms.
   d) Incorrect – The bankruptcy exclusion only applies if the debt is discharged in the bankruptcy.

4. Details surrounding the qualified principal residence exclusion include which of the following? **(Pages 12-13)**

   a) Incorrect – The exclusion is available until January 1, 2015.
   b) Incorrect – It does not include home equity indebtedness for which mortgage interest may be allowable as a deduction under IRC §163(h)(3)(C).
   c) Incorrect – There are two differences: Qualified principal residence indebtedness is limited to $2 million, whereas acquisition indebtedness is limited to $1 million, and qualified principal residence indebtedness applies solely to a taxpayer's principal residence, whereas acquisition indebtedness can be incurred for the principal residence and one other residence.
   d) Correct – A second home cannot be included.

THE QUALIFIED FARM INDEBTEDNESS EXCLUSION

A discharge of qualified farm indebtedness does not result in discharge of indebtedness income. (IRC §108(a)(1)(C)) This exclusion does not apply, however, to the extent that the insolvency or bankruptcy exclusions apply. (IRC §108(a)(2)(A) and (B))

Qualified farm indebtedness is indebtedness incurred directly in connection with the taxpayer's operation of the trade or business of farming, but only if 50% or more of the taxpayer's aggregate gross receipts for the three taxable years prior to the taxable year in which the discharge of indebtedness occurs is attributable to the trade or business of farming. (IRC §108(g)(2))

The debt must be discharged by a "qualified person," which means anyone who is actively and regularly engaged in the business of lending money, is not related to the taxpayer, is not a person from whom the taxpayer acquired the property (or a person related to such person), and is not a person who receives a fee from the taxpayer's investment in the property (or a person related to such person). A "qualified person" includes any governmental agency. (IRC §108(g)(1))

California conformity

California conforms to the farm exclusion.

THE EXCLUSION FOR CANCELLATION OF STUDENT LOANS

The discharge of student loans does not give rise to discharge of indebtedness income if the discharge is pursuant to a provision in the loan agreement under which all or a part of the student loan is forgiven, so long as the student works for a certain period of time in certain professions for any of a broad class of employers.

In addition, an individual's gross income does not include forgiveness of loans made by tax-exempt charitable organizations (e.g., educational organizations or private foundations) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. (IRC §108(f)(3))

This provision applies to a law school's loan repayment assistance program that forgives all or part of a student's debt if the graduate completes a period of employment in law-related public service position. (Rev. Ruls. 2008-28, 2008-34)

California conformity

California conforms to the exclusion for student loan forgiveness.

THE EXCLUSION FOR DISCHARGE OF QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS

While IRC §108 and IRC §121 provide potential exclusions on a principal residence for solvent taxpayers, IRC §108 also provides a potential exclusion for another class of solvent taxpayers: owners of qualified business real property.

Taxpayers (other than C corporations) may elect to exclude from gross income certain income from discharge of qualified real property business indebtedness. The amount so excluded is treated as a reduction in the taxpayer's basis of certain depreciable real property and cannot exceed the basis of that property. (IRC §108(c))

Note: As previously observed, the bankruptcy exclusion and the insolvency exclusion both take precedence over the qualified business real property exclusion.

Qualified real property business indebtedness must meet three requirements:

- It was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property;
- It was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness; and
- The taxpayer elects to exclude COD income with respect to such indebtedness. (IRC §108(c)(3))

Qualified acquisition indebtedness (the second requirement) is debt that is incurred or assumed to acquire, construct, or substantially improve real property used in a trade or business. (IRC §108(c)(4)) Refinancing indebtedness also qualifies, but only to the extent that it doesn't exceed the refinanced indebtedness (the principal balance of the debt paid off by the refinanced loan). However, to the extent that the proceeds from the refinanced loan are used to substantially improve the property, that portion will qualify. But if the proceeds from the refinanced loan are not used to substantially improve the property, that portion won't be eligible for the exclusion.

The election is made on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and §1082 Basis Adjustment), on the tax return for the year in which the cancellation occurs. It must be filed by the due date of the return, including extensions. (Treas. Regs. §1.108-5(b)) However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within six months of the due date of the return, excluding extensions. (See instructions to Form 982, citing Treas. Regs. §301.9100-2)

California conformity

California conforms to the real business property exclusion. A taxpayer may not make a separate election. However, the excludable amount may be different due to basis differences. California does not have an equivalent form. File a separate federal Form 982 reporting California amounts, if different.

Does rental property qualify for the exclusion?

To qualify for the exclusion, the debt must be incurred in connection with real property used in a business. Historically, the courts have held that the rental of even a single property may constitute a business under various provisions of the Code (see, e.g., ***Curphey v. Comm***. (1980) 73 TC 766, 773; ***Hazard v. Comm.*** (1946) 7 TC 372; ***Post v. Comm.*** (1956) 26 TC 1055; ***Gilford v. Comm.*** (1953) 201 F.2d 735; ***Schwarcz v. Comm.*** (1955) 24 TC 733; ***Elek v. Comm***. (1958) 30 TC 731; ***Fegan v. Comm.*** (1979) 71 TC 791, aff'd. 81-1 USTC (1981); ***Pinchot v. Comm.*** (1940) 113 F.2d 718).

But this is not always true, such as where the taxpayer is essentially an investor or the lease is a "net lease." (***Neili*** (1942) 46 B.T.A. 197; Rev. Rul. 73-522, 1973-2 C.B. 226) The issue is ultimately one of fact in which the scope of a taxpayer's activities, either personally or through agents, in connection with the property, are so extensive as to rise to the stature of a trade or business. (***Bauer v. United States*** (1958) 168 F. Supp. 539, 541; ***Schwarcz v. Comm.*** (1955) 24 TC 733)

In TAM 8350008, the IRS announced that it was taking the position that the mere rental of real property does not constitute a trade or business under IRC §1231. As a result, taxpayers may be concerned about whether the IRS will allow the IRC §108(c) exclusion for rental property because the language of IRC §108(c)(3)(A) is nearly identical to IRC §1231. The IRS allowed the exclusion for a multi-tenant office building held by a limited partnership and for a multi-unit residential building held by a general partnership (PLRs 9426006–9426019 and 9840026), but what about renting a single-family residence?

Ultimately, the issue depends upon the facts and circumstances. If the taxpayer rents the residence continuously to an unrelated party for a fair market rent, then it will probably be considered a business. (***Mayes v. U.S.*** (1986) U.S. District Court, Western District of Missouri, Docket No. 84-5157-CV-SW-0) The IRS hinted at this in CCA 200919035.

Limitations on exclusion

The amount excluded under this provision generally cannot exceed the lesser of:

- The amount by which the principal amount of the debt that is discharged exceeds the FMV of the property securing the debt; or
- The taxpayer's basis in depreciable real property.
  (IRC §108(c)(2))

The taxpayer must reduce the basis of the depreciable real property by the excluded amount at the beginning of the taxable year following the taxable year in which the discharge occurs.

FMV limitation

Under the FMV limitation, the debt discharge income that can be excluded may not exceed the excess of the outstanding principal amount of debt (immediately before the discharge) over the FMV (immediately before the discharge) of the business real property that secures the qualified real property business indebtedness, reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by the property (immediately before the discharge).

Example of exclusion limitations

Ashley (who is neither bankrupt nor insolvent) owns a building with a FMV of $500,000 that she uses in a trade or business. The balance of the first mortgage is $350,000, and the balance of the second is $200,000. Both loans are qualified real property business indebtedness.

The holder of Ashley's second mortgage agrees to reduce the debt from $200,000 to $125,000, resulting in COD income of $75,000.

Assuming that Ashley has sufficient depreciable basis in qualifying business real property to absorb the reduction, she can exclude $50,000 of that discharge from gross income. Her exclusion is limited to $50,000 because that is the amount by which the balance of the debt (immediately before the discharge) exceeded the FMV of the property (immediately before the discharge).

The remaining $25,000 of discharge is included in her gross income.

Depreciable basis limitation

Under the depreciable basis limitation, the amount of debt discharge income that can be excluded may not exceed the aggregate adjusted basis of depreciable real property held by the taxpayer immediately before the discharge. (IRC §108(c)(2)(B)) This aggregate basis limitation must be determined after any basis reductions occurring as a result of the application of the other IRC §108 exclusions for bankruptcy, insolvency, or qualified farm indebtedness.

REDUCTION OF TAX ATTRIBUTES

When a taxpayer excludes COD income under any of the exclusion provisions, the taxpayer must reduce tax attributes. What attributes must be reduced and the results obtained when a taxpayer eventually disposes of the property depend on which of the exclusions the taxpayer used to exclude the income.

PRINCIPAL RESIDENCE EXCLUSION

Where COD income is excluded under the principal residence provision, the only reduction required in tax attributes is a reduction of the basis in the residence itself. (IRC §108(h)(1)) This basis reduction often doesn't apply because debt discharge on a principal residence often happens in a foreclosure. No basis reduction is required in a foreclosure because the taxpayer no longer owns the residence.

Example of principal residence basis reduction

Alice purchased her principal residence in 2006 for $350,000 with no money down, taking out a $350,000 first trust deed. In 2014, its value had declined to $200,000 when the mortgage balance was $340,000. The bank agreed to drop the mortgage balance to $240,000; that is, the bank forgave $100,000 of the mortgage.

Because the mortgage was qualifying acquisition indebtedness on a qualifying residence, she must reduce the basis of her home by $100,000, so the new basis is $250,000.

INSOLVENCY AND BANKRUPTCY

In the case of an exclusion involving the bankruptcy, insolvency, or farm indebtedness provisions, specific tax attributes of the taxpayer must be reduced by the amount excluded from income, unless the taxpayer elects to apply all or any portion of the excluded amount first to reduce his basis in depreciable assets (or in real property held as inventory). (IRC §§108(b)(5), 1017(b)(3)(A)) The taxpayer must reduce the following tax attributes in the following order:

- NOLs and carryovers;
- Carryovers of the general business credit;
- The minimum tax credit available under IRC §53(b);
- Capital losses and carryovers;
- The basis of assets (both depreciable and nondepreciable);
- Passive activity losses and carryovers; and
- Carryovers of the foreign tax credit.

Generally, you reduce the attributes dollar for dollar by the amount of income excluded. However, you reduce credits (general business credits, minimum tax credits, or foreign tax credits) by 33⅓ cents for every dollar of income excluded. (IRC §108(b)(3))

Any amount of debt discharge left over after the reduction of tax attributes is disregarded; that is, it does not result in income or have any other tax consequences. (Treas. Regs. §1.108-7(a)(2))

No basis reduction on "exempt assets" in bankruptcy

If a debt is discharged in bankruptcy, certain property is exempt from the basis reduction. (IRC §1017(c)(1)) These exempt assets generally include retirement plans and may include limited values for personal residence, automobiles, household goods and furnishings, and others.

Limitations on reduction in basis

If the bankruptcy or insolvency provisions are invoked, the reduction in basis is limited to the excess of:

- The aggregate of the adjusted basis of property and the amount of money held by the taxpayer immediately after the discharge; over
- The aggregate of the liabilities of the taxpayer immediately after the discharge. (IRC §1017(b)(2))

This limitation does not apply if the basis reduction is due to the taxpayer's election under IRC §108(b)(5) to first reduce the basis in depreciable property.

Example of limitation on reduction

Ann purchased her residence in 2003 for $600,000, taking out a mortgage of $500,000. In 2007, the value of the property had risen to $1 million, and she took out a second mortgage for $400,000, using all of the funds for personal purposes. In 2014 the bank forgave the loan. On the day of her discharge, this is her personal balance sheet:

	FMV	**Adjusted basis**
Cash	$ 5,000	$ 5,000
Personal effects, home furnishings, auto, etc.	20,000	40,000
Home	500,000	600,000
Credit cards, car loan, other liabilities	(40,000)	(40,000)
First home mortgage	(500,000)	(500,000)
Second home mortgage	(400,000)	(400,000)
Net immediately before discharge	**(415,000)**	*(295,000)*
Add back discharged second mortgage		400,000
Net immediately after discharge		**105,000**

Ann qualifies to exclude the entire discharge of $400,000 under the insolvency provisions because she is insolvent to at least the extent of the discharged debt. Assume she has no tax attributes subject to reduction other than basis in assets. She must reduce the basis of her property by only $125,000 because that is the extent by which the adjusted basis of her assets exceeds her liabilities immediately after the discharge.

Effect of retirement plans

Even if retirement plans are counted for purposes of determining insolvency, they have zero basis. Therefore, they have no effect in determining the limitation on basis reduction (this, however, may be an unfortunate consequence of having a Roth, which has a basis).

Example of limitation on reduction

Assume all the facts of the prior example, but also assume that Ann has an IRA:

	FMV	**Adjusted basis**
Cash	$ 5,000	$ 5,000
Personal effects, home furnishings, auto, etc.	20,000	40,000
Home	500,000	600,000
IRA	50,000	0
Credit cards, car loan, other liabilities	(40,000)	(40,000)
First home mortgage	(500,000)	(500,000)
Second home mortgage	(400,000)	(400,000)
Net immediately before discharge	(365,000)	(295,000)
Add back discharged second mortgage		400,000
Net immediately after discharge		105,000

Ann now qualifies to exclude only $365,000, the extent to which she is insolvent. She must include $35,000 in income. She must still reduce basis by $105,000.

Assume Roth

If Ann's IRA were a Roth or nondeductible IRA with a basis of $40,000, it would increase her required basis reduction by that amount. Her required basis reduction would be $145,000.

Timing of reductions

The reduction in tax attributes takes place as of the beginning of the taxable year following the year in which the debt was cancelled. (IRC §1017(a); Treas. Regs. §1.108-7(b))

Accordingly, a taxpayer may get one more bite at using tax attributes that will have to be reduced.

Example of timing of reductions

Frank has credit debt of $10,000 discharged by the bank in 2014. He is insolvent to the full extent of the $10,000 and uses the insolvency provisions to fully exclude the COD. His only tax attributes are personal assets worth $10,000 and a capital loss carryover into 2014 of $10,000. In 2014, he has net capital gains of $5,000 before the carryover. He may use $5,000 of the capital loss carryover to offset the $5,000 of capital gains, and he may deduct a net capital loss of $3,000. As of the beginning of 2015, he must reduce the remaining $2,000 capital loss carryover to zero, and he must reduce the basis of his personal assets by $8,000.

Ordering of reduction in basis

In the case of basis reductions required because COD income is excluded under the bankruptcy or insolvency provisions, basis is reduced in the following order:

- Real property used in a trade or business or held for investment that secured the debt immediately before the discharge, other than real property held as inventory for sale to customers (as described in IRC §1221(a)(1));
- Personal property used in a trade or business other than inventory, accounts receivable, and notes receivable that secured the indebtedness immediately before the discharge;
- Remaining property used in a trade or business other than inventory, accounts receivable, notes receivable, and real property held as inventory for sale to customers;
- Inventory, accounts receivable, and real property held for sale to customers; and
- Property not used in a trade or business.

Example of ordering

Bill purchased a duplex in 2003 for $500,000, taking out a $400,000 mortgage. He used one unit as his principal residence and one as a rental and, since each unit had about the same floor space, he allocated them 50/50. In 2006, he took out a second mortgage of $200,000 and used the funds for personal purposes.

In 2014 the bank forgave the $200,000 second mortgage, and Bill qualifies to exclude the COD income under the insolvency provisions. He has no tax attributes other than basis in property. As much as he might like to reduce the principal residence portion of the property (so that he may eventually use the §121 exclusion to offset gain), he cannot do so because it is property not used in a trade or business and ranks below the rental portion of the property, which is real property used in a trade or business or held for investment.

Allocating within classes of assets

If a taxpayer has multiple assets in any one class subject to reduction, the taxpayer must allocate the reduction in proportion to the total adjusted basis of property in that class. (IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals))

Example of allocating within a class

Frank must reduce basis under the insolvency provisions by $100,000. He has two rental properties. Property A has an adjusted basis of $50,000 and Property B has an adjusted basis of $200,000. He must reduce the basis of Property A by $20,000 and Property B by $80,000.

Election to reduce basis first

Rather than reduce tax attributes, a taxpayer can elect to reduce basis in depreciable property or in real property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. (IRC §§108(b)(5), 1017(b)(3)(E)) However, the reduction cannot reduce basis below zero. Any remaining amount is then applied to reduce the other tax attributes in the order described above.

Caution

The limitation on reduction of basis under IRC §1017(b)(2) does not apply under the election to reduce basis.

Example of reducing basis first

Stan has the following assets and liabilities:

	FMV	Adjusted basis
Cash	$ 5,000	$ 5,000
Personal effects, home furnishings, auto, etc.	20,000	40,000
Rental property	400,000	500,000
Recourse loan	(200,000)	(200,000)
Mortgage on rental property	(640,000)	(640,000)
Net immediately before discharge	(415,000)	(295,000)
Add back discharged recourse loan		200,000
Net immediately after discharge		(95,000)

The bank forgives the $200,000 recourse loan in 2014. Stan may use the insolvency provisions to exclude the entire cancellation of debt.

Assume further that Stan has an NOL carryforward into 2015 of $35,000 and a passive loss carryforward of $25,000. Assume he is still working and will have salary income of $100,000 in 2015.

If Stan does not elect to reduce basis first, he must reduce his $35,000 NOL to zero. He does not have to reduce basis of assets because of the limitation rule on reduction of basis (his aggregate liabilities exceed his aggregate basis). He will then have to reduce his $25,000 passive loss carryover to zero. No other reductions are required.

If Stan elects to reduce basis first, he would reduce the basis of his rental property by $200,000.

Why reduce basis first?

In the example, Stan would lose $200,000 of tax attributes if he elects to reduce basis first, but only $60,000 of attributes if he doesn't ($35,000 NOL + $25,000 passive loss). Stan might elect to reduce basis because:

- He makes $100,000 per year and can use both the NOL and passive loss carryovers in 2014, getting a big, immediate tax benefit. He may plan to hold the rental property for many years;
- He is in ill health and will pass on the property to an heir who will get to step up the basis of the property, thereby negating the effects of the basis reduction.

Will you ever sell your stocks?

A good use of the election to reduce basis first is when a taxpayer has useful tax attributes (such as an NOL carryforward) and only has personal assets of the type that will never be sold.

Example of reducing basis first

Jean has the following assets and liabilities:

	FMV	Adjusted basis
Cash	$1,000	$1,000
Personal effects, home furnishings, auto, etc.	20,000	40,000
Credit card debt	(25,000)	(25,000)
Net immediately before discharge	(4,000)	16,000
Add back discharged credit card debt		5,000
Net immediately after discharge		21,000

$5,000 of Jean's credit card debt is discharged in 2014. She is insolvent to the extent of $4,000, so she can exclude $4,000 under the insolvency provisions, but she must include $1,000 in income. She has a $10,000 NOL carryforward into 2015.

Without making the election to reduce basis first, she must reduce her NOL carryforward to $6,000. If she makes the election to reduce basis first, she will reduce the basis of her only assets: personal assets that she will likely never sell. By making the election, she preserves her full $10,000 NOL carryforward.

BUSINESS REAL PROPERTY

If a taxpayer elects the qualified real property business indebtedness exclusion under IRC §108(c), the amount of discharge of indebtedness that is excluded from income causes a reduction in the basis of the taxpayer's depreciable real property. (IRC §108(c)(1)(A)) This basis reduction is applied only to the basis of depreciable real property. (IRC §1017(b)(3)(A)) The election to treat real property held as inventory as depreciable property does not apply. (IRC §1017(b)(3)(F)(ii))

Generally, the basis reduction takes effect on the first day of the tax year following the tax year in which the discharge takes place. (IRC §1017(a)) However, if the taxpayer disposes of the real property before the beginning of the next tax year, the reduction in basis is made immediately before the disposition of the property. (IRC §1017(b)(3)(F)(iii))

Example of business real property basis reduction

Ashley, who is neither bankrupt nor insolvent, receives COD income of $75,000 due to the reduction of a mortgage on real property that she uses in a trade or business. Ashley qualifies to exclude the entire amount under the business real property exclusion. She must reduce the basis of the building by $75,000.

EFFECT OF BASIS REDUCTIONS ON SUBSEQUENT DISPOSITIONS

For recapture purposes, any reduction of basis of property due to debt discharge under the bankruptcy or insolvency provisions is treated as a depreciation deduction. (IRC §1017(d)(1)(B)) For that purpose, all property is treated as IRC §1245 property, except for IRC §1250 property, which is treated as IRC §1250 property. Thus, personal property not used in a trade or business or for investment is treated as IRC §1245 property.

Therefore, the reduction amount produces ordinary income or IRC §1250 recapture, to the extent of gain, upon a taxable disposition of the property.

Example of sale of reduced-basis property

In a prior year, Jack reduced the basis of a rental property by $50,000 after using the real property business exclusion. In 2014, he sells the property for $500,000, when it has a cost basis of $350,000 and actual accumulated depreciation of $40,000. The adjusted basis at the time of sale is, therefore, $260,000. Of his $240,000 gain, $90,000 is IRC §1250 recapture and $150,000 is capital gain.

The principal residence

The requirement to reduce basis incident to the principal residence exclusion is contained in a different code section than the requirements under other exclusion provisions. (IRC §108(h)(1)) Under that provision, the basis reduction is *not* treated as depreciation. Therefore, the IRC §121 exclusion may be applied to offset gain resulting from the basis reduction.

If the basis reduction to a principal residence occurs incident to any other exclusion provision, the same principles apply that also apply when a portion of a principal residence has been used for business purposes and has been depreciated; that is, the IRC §121 exclusion does not apply to the extent that gain is attributable to depreciation adjustments. (Treas. Regs. §1.121-1(e)(1))

Example of sale of reduced-basis principal residence

In a prior year, Jerry reduced the basis of his principal residence by $50,000, under the principal residence exclusion, from $300,000 to $250,000. In 2014, he sells the home for $340,000. He qualifies to use the IRC §121 exclusion. He may exclude the entire $90,000 of gain under IRC §121.

Assume instead that in the prior year he had used the insolvency exclusion and had reduced the basis of his principal residence. In that case, $50,000 of his gain would be IRC §1250 recapture that could not be excluded. The remaining $40,000 gain could be excluded under IRC §121.

PROPERTY CONVERTED FROM PERSONAL TO BUSINESS USE, OR VICE VERSA

If a taxpayer's principal residence is subsequently converted to rental use, or vice versa, and there is COD income from a foreclosure or similar transaction, which exclusion under IRC §108 applies? Is it the Qualified Principal Residence Indebtedness exclusion, or the Qualified Real Property Business Indebtedness exclusion under IRC §108(a)(1)(D) and (c)?

The statute states that the exclusion depends upon "the indebtedness discharged." (IRC §§108(a)(1)(D) and (E)) Accordingly, whether the taxpayer qualifies for the principal residence exclusion or the real property business exclusion depends upon the use of the property at the time the debt is canceled. If the property is being used as the taxpayer's principal residence, the principal residence exclusion applies. If the property has been converted to rental use, the real property business exclusion applies.

Taxpayers must be careful about abandoning property because they could potentially invalidate their eligibility for an exclusion when they do so. If, for example, a taxpayer abandons property used in a business and six months later the lender forecloses on the property and cancels the debt, the IRS could argue that the taxpayer is not eligible for the real property business exclusion because the property was not being used in a trade or business at the time that the debt was canceled. A similar argument could be used concerning an abandoned personal residence.

One strategy that has been recommended to clients who owe more on a personal residence than it's worth, who are facing a large tax bill due to debt that doesn't qualify for the exclusion (e.g., the debt exceeds the statutory $2 million limit), and who want to purchase a new personal residence before the lender forecloses and damages their credit, is to purchase the new personal residence and convert the old residence into a rental.

These clients may not be eligible for a full exclusion of COD income under the federal principal residence exclusion rules due to the nonqualified debt and may not be entitled to any exclusion under California law.

Converting the old residence to a rental and renting the property until the lender forecloses may make them eligible for the real property business indebtedness exclusion, to which California law conforms.

USING IRC §121 IN A FORECLOSURE

To the extent that there is gain (not COD income) from a foreclosure, a taxpayer may use the rules under IRC §121 to exclude some or all of the gain.

Under IRC §121, a taxpayer can exclude up to $250,000 of the gain ($500,000 for married filing joint) on the sale of a house if the house is used as the taxpayer's primary residence for two of the past five years, among other requirements.

It is important to note the distinction between COD income and gain on the disposition of the taxpayer's principal residence, because COD income may not be excluded under IRC §121.

- Only IRC §108 pertains to exclusions of COD income.
- IRC §121 applies to the exclusion of gain on the disposition of the residence.

Let's revisit Lila Bility.

Example of foreclosure on nonrecourse debt on a principal residence

In the example above, Lila's debt was nonrecourse.

Nonrecourse debt	$300,000
Basis	(250,000)
Gain	$ 50,000

There is no COD income on this foreclosure.

As there is no COD income on this foreclosure, the transaction does generate a taxable gain. However, if she otherwise qualifies, she may still exclude the gain under IRC §121.

REPORTING THE COD

On a discharge of debt, the lender is required to provide the debtor with Form 1099-C, Cancellation of Debt. (IRC §6050P) This form includes the following information:

- Box 1: Date of cancellation;
- Box 2: Amount of debt canceled;
- Box 3: The amount of accrued interest included in Box 2. (As previously noted, the amount of interest is not included in income for a cash-basis taxpayer. (IRC §108(e)(2)) As such, the cash-basis taxpayer will subtract this amount from the Box 2 amount to arrive at the principal amount of debt canceled.);
- Box 4: Description of the debt;
- Box 5: A checkbox to indicate whether the borrower was personally liable for the debt (recourse debt) has been added in the 2009 version of the form;
- Box 6: A checkbox to indicate that cancellation was due to bankruptcy; and
- Box 7: The FMV of the property.

If the lender acquires the property by foreclosure or by abandonment by the borrower, but does not cancel any debt, the borrower may receive Form 1099-A, Acquisition or Abandonment of Secured Property. (IRC §6050J) This form includes the following information:

- Box 1: Date of acquisition or abandonment;
- Box 2: The amount of principal outstanding;
- Box 4: FMV of the property;
- Box 5: A checkbox to indicate whether the borrower was personally liable for the debt (recourse debt); and
- Box 6: Description of the property.

A lender **may** issue both Forms 1099-A and 1099-C if the lender cancels the debt in connection with acquisition of the property (e.g., foreclosure). However, in such a situation, the lender need only issue Form 1099-C. (Treas. Regs. §1.6050P-1(e)(3))

FORM 1099-C

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Date of identifiable event 2 Amount of debt discharged $ 3 Interest if included in box 2 $	OMB No. 1545-1424 **2015** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S federal identification number	DEBTOR'S identification number	4 Debt description		**Copy B** **For Debtor** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code		5 If checked, the debtor was personally liable for repayment of the debt . . . . ▶ ☐		
Account number (see instructions)		6 Identifiable event code	7 Fair market value of property $	

Form **1099-C** (keep for your records) www.irs.gov/form1099c Department of the Treasury - Internal Revenue Service

FORM 1099-A

☐ CORRECTED (if checked)

LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.			OMB No. 1545-0877 2015 Form 1099-A	**Acquisition or Abandonment of Secured Property**
LENDER'S federal identification number	BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment	2 Balance of principal outstanding $	**Copy B** **For Borrower** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
BORROWER'S name		3	4 Fair market value of property $	
Street address (including apt. no.)		5 If checked, the borrower was personally liable for repayment of the debt . . . . ▶ ☐		
City or town, state or province, country, and ZIP or foreign postal code		6 Description of property		
Account number (see instructions)				

Form **1099-A** (keep for your records) www.irs.gov/form1099a Department of the Treasury - Internal Revenue Service

For individual taxpayers, the taxable amount of COD income is reported:

- On Schedule C if the debt was related to the trade or business;
- On Schedule E if the debt was related to rental property or another asset reported on Schedule E;
- On Schedule F if the debt relief is for farming debt; or
- On Form 1040, line 21, Miscellaneous Income, for personal residences and other personal forgiven debts.

The capital gain or loss portion is reported on Schedule D, Capital Gains and Losses, or Form 4797, Sales of Business Property, as appropriate.

In addition, file Form 982 to claim any exclusions under IRC §108. On this form, you report reduction of tax attributes, including the election under IRC §108(b)(5) to apply the reduction first to reduce the basis of depreciable property.

The instructions to Form 982 state that you must attach a statement to the return describing the transaction resulting in the reduction of basis under IRC §1017.

Form **982**

(Rev. July 2013)

Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ **Attach this form to your income tax return.**

▶ **Information about Form 982 and its instructions is at *www.irs.gov/form982*.**

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return | **Identifying number**

Part I General Information (see instructions)

1	Amount excluded is due to (check applicable box(es)):		
a	Discharge of indebtedness in a title 11 case		☐
b	Discharge of indebtedness to the extent insolvent (not in a title 11 case)		☐
c	Discharge of qualified farm indebtedness		☐
d	Discharge of qualified real property business indebtedness		☐
e	Discharge of qualified principal residence indebtedness		☐
2	Total amount of discharged indebtedness excluded from gross income	**2**	
3	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?		☐ Yes ☐ No

Part II Reduction of Tax Attributes.

You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness applied to reduce the basis of depreciable real property	**4**	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	**5**	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	**6**	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge .	**7**	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	**8**	
9	Applied to reduce any net capital loss for the tax year of the discharge, including any capital loss carryovers to the tax year of the discharge	**9**	
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	**10a**	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	**10b**	
11	For a discharge of qualified farm indebtedness applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business or for the production of income if not reduced on line 5	**11a**	
b	Land used or held for use in a trade or business of farming	**11b**	
c	Other property used or held for use in a trade or business or for the production of income . . .	**11c**	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	**12**	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge . . .	**13**	

Part III Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)

Under section 1081(b), the corporation named above has excluded $ ______________________ from its gross income for the tax year beginning ______________________ and ending ______________________.
Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ____.

(State of incorporation)

Note. *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

INCORRECT FORMS

What should you do if the Form 1099-A or Form 1099-C contains incorrect information, such as the amount of debt canceled or the FMV of the property? First, contact the lender and ask to have the form corrected. If the lender won't issue a corrected form, then report the correct information on the return and attach a statement to the return explaining the difference in reporting.

For example, many lenders will report, as the FMV of the property, the price at which the foreclosed property was sold at a trustee's sale. A trustee's sale is generally considered a forced sale and, therefore, the selling price may be substantially less than the true FMV. Because a higher FMV will result in a lower amount of COD income, it is generally more advantageous for the taxpayer to report a higher FMV. Evidence of comparable sales, a real estate agent's opinion of value, or an appraisal should be obtained to support the FMV being reported when it is different from the amount shown on the Form 1099-C.

COD CASE STUDY — THE TANGLED WEB

Amy weaved a tangled web without first practicing to deceive. The facts of her case are:

- She purchased a duplex for $1.2 million in 2006, taking out a first mortgage of $1 million;
- She lived in one unit as her principal residence and rented out the other;
- The units are equal in size, so 50% of the basis was allocated to each unit;
- When it appreciated, she took out a second mortgage for $500,000, using all of the funds for purposes that are now mostly forgotten, irrelevant (like her daughter's college tuition), or undocumented (she says she used "some" of the funds to improve the property);
- The property declined in value, and Amy stopped making payments on the second mortgage; and
- In 2013, the bank forgave the second mortgage and issued a Form 1099-C.

Insolvency

Had Amy documented the improvements, she may have used the discharge of qualified principal residence exclusion to exclude a portion of the discharge.

However, Amy is insolvent. She can use the insolvency exclusion and avoid taking the entire $500,000 into income in the year of discharge.

To the extent that she must use the insolvency exclusion, she believes that she will allocate the reduction of basis 50/50 between the rental unit and the principal residence. Therefore, half of the reduction will go to the principal residence, and when she eventually sells the property, her IRC §121 exclusion will negate the effect of half of the basis reduction. This is what she believes, but as we'll see in a moment, that is not how the insolvency exclusion works in her situation.

Can she use the insolvency exclusion?

Amy is insolvent to the extent of $415,000. If she uses the insolvency exclusion, she can exclude $415,000, but must include $85,000 in current income.

	FMV before discharge	Adj. basis after discharge but before basis reduction
Assets:		
Cash, personal effects, autos, etc.	$20,000	40,000
Commonwealth property	977,000	1,100,000
Marlboro property (second rental)	150,000	80,000
Retirement accounts	105,000	-
Total assets	1,252,000	1,220,000
Liabilities:		
Misc. debts (auto loan, credit cards)	45,000	45,000
Commonwealth first mortgage	944,000	944,000
Commonwealth second mortgage	500,000	-
Marlboro mortgage	178,000	178,000
Total liabilities	1,667,000	1,167,000
Net	($415,000)	$53,000

Reducing tax attributes

In the case of an exclusion involving the insolvency provisions, specific tax attributes of the taxpayer must be reduced by the amount excluded from income, unless the taxpayer elects to apply all or any portion of the excluded amount first to reduce his basis in depreciable assets (or in real property held as inventory). (IRC §§108(b)(5), 1017(b)(3)(A))

The tax attributes must be reduced in a certain order, and one of the attributes is basis of property. Amy must reduce the basis of property because she doesn't have any of the tax attributes that precede basis in the ordering. Basis of property must be reduced in a certain order with real property used in a trade or business or for investment heading the list, and property not used in a trade or business bringing up the rear.

Therefore, Amy's theory that she can apply the reduction of tax attributes equally between the rental portion of the property and the residence portion doesn't wash. She must apply the entire reduction to the rental portion of the property.

But … there's a limit on the reduction of basis

If the bankruptcy or insolvency provisions are invoked, the reduction in basis is limited to the excess of:

- The aggregate of the adjusted basis of property and the amount of money held by the taxpayer immediately after the discharge; over
- The aggregate of the liabilities of the taxpayer immediately after the discharge. (IRC §1017(b)(2))

Any amount of debt discharge left over after the reduction of tax attributes is disregarded; that is, it does not result in income or have any other tax consequences. (Treas. Regs. §1.108-7(a)(2))

Therefore, Amy must reduce the basis of her rental property by only $53,000 (the excess of adjusted basis over liabilities immediately after the discharge).

Note: This limitation does *not* apply to basis reduction if the taxpayer makes the election to reduce basis first. It only applies when a taxpayer has gone through the list of tax attributes under the ordering rules for reduction of tax attributes and has arrived at basis.

Applying the reduction

If a taxpayer has multiple assets in any one class subject to reduction, the taxpayer must allocate the reduction in proportion to the total adjusted basis of property in that class. (IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)) Therefore, she must apply the $53,000 reduction to her Marlboro property and the rental portion of her Commonwealth property in proportion to their adjusted bases after the discharge.

After-effect of basis reduction

Any reduction of basis of property due to debt discharge under the bankruptcy or insolvency provisions is treated as a depreciation deduction. (IRC §1017(d)(1)(B)) For that purpose, all property is treated as IRC §1245 property, except for IRC §1250 property, which is treated as IRC §1250 property. Thus, even personal property (that is not used in a trade or business or for investment) is treated as IRC §1245 property.

Therefore, the reduction amount reduces depreciation deductions in subsequent years and produces ordinary income or IRC §1250 recapture, to the extent of gain, upon a taxable disposition of the property.

Basis Allocation						
Property	**Cost basis**	**Accum. deprec. before adjustment**	**Adjusted basis before reduction**	**Reduction**	**Accum. deprec. after reduction**	**Adjusted basis after reduction**
Commonwealth residence	$600,000		$600,000			$600,000
Commonwealth rental	$600,000	$100,000	$500,000	* $45,690	$145,690	$454,310
Marlboro	$150,000	$70,000	$80,000	** $7,310	$77,310	$72,690
Total	$1,350,000	$170,000	$1,180,000	$53,000	$223,000	$1,127,000

* ($500,000 ÷ ($500,000 + $80,000)) × $53,000 = $45,690

** ($80,000 ÷ ($500,000 + $80,000)) × $53,000 = $7,310

Form **1040** Department of the Treasury — Internal Revenue Service (99)
U.S. Individual Income Tax Return **2013**
OMB No. 1545-0074 IRS Use Only — Do not write or staple in this space.

For the year Jan 1 - Dec 31, 2013, or other tax year beginning , 2013, ending , 20 — See separate instructions.

Your first name and initial	Last name	Your social security number
AMY JONES		404-04-0404
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see instructions.	Apartment no.	▲ Make sure the SSN(s) above and on line 6c are correct.
1234 NOWHERE		
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign**
SOMEWHERE, CA 91111		Check here if you, or your spouse if filing jointly, want $3 to go to this fund? Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county / Foreign postal code	

Filing Status

Check only one box.

1 [X] Single
2 [ ] Married filing jointly (even if only one had income)
3 [ ] Married filing separately. Enter spouse's SSN above & full name here. . . ►
4 [ ] Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here . ►
5 [ ] Qualifying widow(er) with dependent child

Exemptions

6a [X] **Yourself.** If someone can claim you as a dependent, **do not** check box 6a. — Boxes checked on 6a and 6b: 1
b [ ] **Spouse**

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax cr (see instrs)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here . . ► ☐

No. of children on 6c who:
- lived with you . . . . .
- did not live with you due to divorce or separation (see instrs) . . .

Dependents on 6c not entered above . .

d Total number of exemptions claimed. — Add numbers on lines above . . . . ► 1

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	80,000.
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends — 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Att Sch D if reqd. If not reqd, ck here ► ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions — 15a — b Taxable amount	15b	
16a	Pensions and annuities — 16a — b Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits — 20a — b Taxable amount	20b	
21	Other income Cancellation of Debt	21	85,000.
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ►	22	165,000.

Adjusted Gross Income

23	Educator expenses	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	Deductible part of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN . . . . ►	31a	
32	IRA deduction	32	
33	Student loan interest deduction	33	
34	Tuition and fees. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 35	36	0.
37	Subtract line 36 from line 22. This is your **adjusted gross income** ►	37	165,000.

Form **982** (Rev. July 2013)

Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

► **Attach this form to your income tax return.**

► **Information about Form 982 ad its instructions is at *www.irs.gov/form982***

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return	Identifying number
AMY JONES	404-04-0404

Part I General Information (see instructions)

1 Amount excluded is due to (check applicable box(es)):

a Discharge of indebtedness in a title 11 case . . . . . [ ]

b Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . . . [X]

c Discharge of qualified farm indebtedness. . . . . [ ]

d Discharge of qualified real property business indebtedness . . . . . [ ]

e Discharge of qualified principal residence indebtedness . . . . . [ ]

2	Total amount of discharged indebtedness excluded from gross income	2	415,000.

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? . . . . . [ ] Yes [X] No

Part II Reduction of Tax Attributes

You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9	Applied to reduce any net capital loss for the tax year of the discharge, including any capital loss carryovers to the tax year of the discharge	9	
10 a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	10 a	53,000.
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	10 b	
11	For a discharge of qualified farm indebtedness applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business or for the production of income if not reduced on line 5	11 a	
b	Land used or held for use in a trade or business of farming	11 b	
c	Other property used or held for use in a trade or business or for the production of income	11 c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13	

Part III Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)

Under section 1081(b), the corporation named above has excluded $ ____________ from its gross income for the tax year beginning ____________ and ending ____________.

Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ____________.

(State of incorporation)

Note: *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

Cancellation of Debt - Insolvency

Debtor AMY JONES ID# 404-04-0404

Tax year 2013

Cancelled Debt	Creditor		Amount
FORM 1099-C:	SECOND MORTGAGE		500,000
FORM 1099-C:			
FORM 1099-C:			
	A. Total Cancelled Debt	$	500,000

Date of Cancellation and Valuation of Assets/Liabilities July 1, 2013

Assets

Cash - checking accounts		20,000
Cash - savings accounts		
Certificates of deposit		
Securities (stocks, bonds, mutual funds)		
Notes and contracts receivable		
Life insurance (cash surrender value)		
Personal property (art, jewelry, etc.)		
Retirement funds (IRAs, 401(k), etc.)		105,000
Automobile #1		
Automobile #2		
Business assets (machinery & equipment)		
Real estate (market value)		1,127,000
Other assets (specify)		
B. Total Assets	$	1,252,000

Liabilities

Current debt (credit cards, accounts)		45,000
Notes payable		
Auto loans payable		
Education, student loans		
Taxes payable		
Real estate mortgages		1,622,000
Other liabilities (specify)		
C. Total Liabilities	$	1,667,000
D. Amount of Insolvency (C - B, NOT < 0)	$	415,000
E. Amount excluded from Income (lesser of A or D)	$	415,000
F. Amount Included in Income (A - D)	$	85,000

Explanation:

Prepared By:

Spidell Publishing, Inc.
1134 N. Gilbert St.
Anaheim CA 92801
Tel: (714) 776-7850

04-28-2014

Single, free, and moving on

Assume that in 2014 the real estate market has shot up, and Amy decides she wants to get out from under her house and move on. She sells the house for $1.4 million, allocating the sales price 50/50 between personal and rental. (Assume also that she's taken another $24,310 of depreciation on the Commonwealth rental, so the adjusted basis is $430,000 at the time of sale.) She occupied the residence continuously from the time of purchase in 2006 to the time of sale in 2014.

	Personal	**Rental**
Sales price	$700,000	$700,000
Adjusted basis	$600,000	$430,000
Gain	$100,000	$270,000
IRC §121 exclusion	$250,000	
Recognized gain	$0	$270,000
Accumulated depreciation (IRC §1250 gain)		$170,000
Capital gain		$100,000

Net investment income tax

One downside to the timing of her sale is that she will be subject to the 3.8% net investment income tax (NIIT) in 2014. Assume that the gain on the sale of $270,000 plus her $80,000 salary constitutes her entire AGI of $350,000. Because gains are investment income, her NIIT is based on the lesser of her gain ($270,000) or the excess of her modified adjusted gross income over her threshold amount ($350,000 – $200,000 = $150,000). Therefore, her NIIT will be $5,700.

The final tally

Assuming that Amy's only income in 2013 was her $80,000 salary and the $85,000 COD income, and that her only deductions were the standard deduction and her exemptions, the COD cost her $23,258 in 2013.

In 2014, the only effects of the basis reduction are to increase unrecaptured IRC §1250 gain by the amount of the basis reduction ($45,690) and increase NIIT by the same amount. IRC §1250 gain is taxed at 25% and the NIIT at 3.8%. So the tax in 2014 is $13,159 (28.8% × $45,690).

Her total tax liability due to the COD is $36,417 over two years.

COD INCOME FROM FLOW-THROUGH ENTITIES

PARTNERSHIPS

Partners must include the partnership's COD income in taxable income unless an exception applies. (IRC §61(a)(12)) Partnerships allocate the COD income to each partner on the Schedule K-1.

The taxability of COD income is determined at the partner level. (IRC §§108(d)(6) and 6231(a)(5)) This means a partner may exclude COD income under IRC §108(a) only if:

- The bankruptcy exclusion applies;
- The partner is insolvent;
- Qualified farm indebtedness is cancelled; or
- Debt is qualified real property business indebtedness, the partner is not a C corporation, and the partner elects to reduce basis in depreciable real property.

Insolvency

A taxpayer qualifies for the insolvency exclusion if the taxpayer's liabilities exceed the taxpayer's fair market value of assets immediately before the discharge. (IRC §108(d)(3))

Whether or not a partnership's debt is treated as a partner's liability for purposes of the insolvency determination depends upon the type of debt owed by the partnership. If the partner is personally liable for a partnership's debt, the loan is a recourse debt. With recourse debt, the general partner and any partner that personally guarantees the loan may include their share of the partnership's recourse liabilities in the partner's computation to determine whether or not the partner is insolvent.

Nonrecourse debt, on the other hand, is a partnership liability that is secured by property, and the partners are not usually held personally liable. However, under Rev. Ruling 2012-14 a partnership's discharged excess nonrecourse debt is treated as a partner's liability for purposes of measuring the partners' insolvency to the extent COD income from the debt is allocated among the partners.

Example of nonrecourse debt

Bob and Betty are equal partners in a partnership and the partnership agreement provides that income will be allocated between them. The partnership takes out a nonrecourse loan from a bank to purchase a building and neither Bob nor Betty are personally liable on the loan.

The next year, the value of the building decreases to $800,000, and the bank agrees to lower the loan amount from $1 million to $820,000. At the time of the loan modification, Bob and Betty have no assets or liabilities other than their interest in the partnership.

The loan modification results in COD income as follows:

- $1,000,000 - $820,000 = $180,000 COD income; and
- $90,000 of the COD income is allocated each to Bob and Betty.

The partners' $90,000 discharged debt is treated as a liability of each of the partners and because their liabilities immediately before the discharge exceed the fair market value of their assets, both Bob and Betty are considered insolvent and qualify for the insolvency exclusion.

Partner's basis in partnership

COD income allocated to a partner increases the partner's basis in the partnership by the amount allocated. At the same time, the reduction in the partner's share of partnership liabilities caused by the debt cancellation results in a deemed distribution which reduces the partner's basis in the partnership.

Example of basis adjustment

Jim invests $1,000 in a partnership in 2010, and his share of partnership debt on real property is $50,000. Thus, his basis in his interest is $51,000.

In 2014, he deducts $6,000, and his share of partnership liabilities does not change. His basis is now $45,000.

In 2015, the bank agrees to a loan modification, reducing Jim's share of partnership liabilities by $10,000 (to $40,000). Jim must report $10,000 of COD income.

Assume there were no other gains, losses, contributions, or distributions in 2015.Therefore, his basis is increased by the $10,000 of COD income and reduced by the $10,000 reduction in his share of the partnership's liabilities. His basis in his interest remains at $45,000.

Note that these basis adjustments are separate and apart from any basis reduction under the general attribute-reduction rules.

Elections

If a partner qualifies for a COD exclusion, then the elections related to the discharge are also made at the partner level. For example, the partner, and not the partnership, would make the election to reduce the basis of depreciable property before reducing other tax attributes.

Only bankrupt partners entitled to the exclusion for discharged partnership liability

The IRS will not follow the Tax Court's rulings in four cases in which it held that the general partners were entitled to exclude COD income arising from the discharge of their personal liabilities for the partnership's debts in a Title 11 bankruptcy proceeding brought by the partnership. (***Action on Decision 2015-1***; ***Gracia v. Comm.***, TCM 2004-147, ***Mirachi v. Comm.***, TCM 2004-148; ***Price v. Comm.***, TCM 2004-149, Estate of ***J. Martinez v. Comm.***, TCM 2004-150)

The IRS is limiting the bankruptcy exclusion for COD income passed through to a general partner from a partnership whose debt was discharged in a Title 11 bankruptcy proceeding to those partners who were involved in the bankruptcy proceeding in their individual capacity.

According to the IRS, Congress's intent in enacting IRC §108(d) was to limit the scope of the bankruptcy exclusion to bankrupt or insolvent partners and not to all partners of a bankrupt partnership. This is in line with the purpose of bankruptcy in general and the COD bankruptcy exclusion in particular, which is to give the "debtor" a fresh start.

S CORPORATIONS

For an S corporation, the bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness exceptions are applied at the entity level, not at the shareholder level. (IRC §108(d)(7)(A))

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

5. For the qualified farm indebtedness exclusions, which of the following applies?

    a) Qualified farm indebtedness is indebtedness incurred directly in connection with the taxpayer's operation of the trade or business of farming, but only if 50% or more of the taxpayer's aggregate gross receipts for the two taxable years prior to the taxable year in which the discharge of indebtedness occurs is attributable to farming.
    b) A discharge of qualified farm indebtedness results in discharge of indebtedness income.
    c) Debt must be discharged by a qualified person, including someone who is actively and regularly engaged in the business of lending money, but not related to the taxpayer.
    d) A governmental agency is not considered a qualified person for the purposes of discharge of debt.

6. Basics for the qualified real property business indebtedness exclusion include which of the following?

    a) The qualified business real property exclusions takes precedence over the insolvency exclusion.
    b) Refinancing indebtedness qualifies for the exclusion, but only to the extent that it doesn't exceed the principal balance of the debt paid off by the refinanced loan.
    c) C corporations may elect to exclude from gross income certain income from discharge of qualified real property business indebtedness.
    d) The election to exclude COD income with respect to qualified real property indebtedness is made on Form 982, and if you timely filed your return for the year without making the election, you can make the election by filing an amended return within six months of the due date of the return, including extensions.

7. If the bankruptcy or insolvency provisions are invoked, which of the following is correct?

    a) Tax attributes and credits (general business credits, minimum tax credits, or foreign tax credits) are reduced dollar for dollar by the amount of income excluded.
    b) Retirement plans are not exempt from basis reduction if a debt is discharged in bankruptcy.
    c) Any amount of debt discharge left over after the reduction of tax attributes is disregarded.
    d) The reduction in basis is limited to the excess of the aggregate of the liabilities of the taxpayer immediately after the discharge over the aggregate of the adjusted basis of property and the amount of money held by the taxpayer immediately after the discharge.

8. What is the effect of basis reductions on subsequent dispositions?

    a) For recapture purposes, personal property not used in a trade or business or for investment is treated as IRC §1250 property.
    b) The requirement to reduce basis incident to the principal residence exclusion is treated as depreciation.
    c) If the basis reduction to a principal residence occurs incident to any other exclusion provision, the IRC §121 exclusion will still apply.
    d) For recapture purposes, any reduction of basis of property due to debt discharge under the bankruptcy or insolvency provisions is treated as a depreciation deduction.

9. When reporting COD, which of the following statements is correct?

    a) For individual taxpayers, report COD on Schedule E if the debt was related to rental property.
    b) If the lender acquires the property by foreclosure or by abandonment by the borrower, but does not cancel any debt, the borrower may receive Form 1099-C, Acquisition or Abandonment of Secured Property.
    c) A lender must issue both Forms 1099-A and 1099-C if the lender cancels the debt in connection with acquisition of the property.
    d) For individual taxpayers, the taxable amount of COD income is reported on Schedule C for personal residences and other personal forgiven debts.

10. As pertains to insolvency in a partnership, which of the following is correct?

    a) Whether or not a partnership's debt is treated as a partner's liability for purposes of the insolvency determination depends upon the nature of the partnership.
    b) Recourse debt is a partnership liability that is secured by property, and the partners can be held personally liable.
    c) If the partner is personally liable for a partnership's debt, the loan is a recourse debt.
    d) Under Rev. Ruling 2012-14, a partnership's discharged excess nonrecourse debt cannot be treated as a partner's liability.

SOLUTIONS TO REVIEW QUESTIONS

5. For the qualified farm indebtedness exclusions, which of the following applies? **(Page 18)**
   a) Incorrect – Gross receipts for the prior three taxable years are considered.
   b) Incorrect – A discharge of qualified farm indebtedness does not result in discharge of indebtedness income.
   c) Correct – Also excluded as a qualified person is someone from whom the taxpayer acquired the property or a person related to such person.
   d) Incorrect – A qualified person includes any governmental agency.
6. Basics for the qualified real property business indebtedness exclusion include which of the following? **(Page 19)**
   a) Incorrect – The bankruptcy exclusion and the insolvency exclusion both take precedence over the qualified business real property exclusion.
   b) Correct – If the proceeds from the refinanced loan are not used to substantially improve the property, that portion won't be eligible for the exclusion.
   c) Incorrect – C corporations may not make the election.
   d) Incorrect – The amended return must be filed within six months of the due date of the return, excluding extensions.
7. If the bankruptcy or insolvency provisions are invoked, which of the following is correct? **(Pages 21-22)**
   a) Incorrect – Generally, you reduce the attributes dollar for dollar by the amount of income excluded, and reduce credits by 33 1/3 cents for every dollar of income excluded.
   b) Incorrect – If a debt is discharged in bankruptcy, certain property is exempt from basis reduction, generally including retirement plans.
   c) Correct – It does not result in income or have any other tax consequences.
   d) Incorrect – The reduction of basis is limited to the excess of the aggregate of the adjusted basis of property and the amount of money held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.
8. What is the effect of basis reductions on subsequent dispositions? **(Pages 26-27)**
   a) Incorrect – Personal property not used in a trade or business or for investment is treated as IRC §1245 property.
   b) Incorrect – The basis reduction is not treated as depreciation.
   c) Incorrect – The IRC §121 exclusion does not apply to the extent that gain is attributable to depreciation adjustments.
   d) Correct – This is true under IRC §1017(d)(1)(B).

9. When reporting COD, which of the following statements is correct? **(Pages 29-30)**

   a) Correct – Schedule C is used if the debt was related to the trade or business and Schedule F is used for farming debt.
   b) Incorrect – In this case, the borrower may receive Form 1099-A, Acquisition or Abandonment of Secured Property. 1099-C is Cancellation of Debt.
   c) Incorrect – In this situation, the lender need only issue Form 1099-C.
   d) Incorrect – For personal residences and other personal forgiven debts, COD is reported on Form 1040, line 21, Miscellaneous Income.

10. As pertains to insolvency in a partnership, which of the following is correct? **(Page 39)**

   a) Incorrect – The decision depends upon the type of debt owed by the partnership.
   b) Incorrect – Nonrecourse debt is a partnership liability that is secured by property, and the partners are not usually held personally liable.
   c) Correct – With recourse debt, the general partner and any partner that personally guarantees the loan may include their share of the partnership's recourse liabilities in the partner's computation to determine whether or not the partner is insolvent.
   d) Incorrect – Under this ruling, a partnership's discharged excess nonrecourse debt is treated as a partner's liability for purposes of measuring the partners' insolvency to the extent COD income from the debt is allocated among the partners.

GLOSSARY

Acquisition indebtedness: can be incurred with respect to a taxpayer's principal residence plus one other residence, such as a vacation home

Adjusted basis: a value used as a starting point to compute depreciation or gain on the disposition of fixed assets for tax purposes

Amortization: the gradual reduction of an amount over time. Examples are amortized expenses on limited life intangible assets and deferred charges. Assets with limited life must be written down over the period benefited

"Anti-deficiency" laws: some states have anti-deficiency laws, under which, if the mortgage is for the purchase of a dwelling occupied by the purchaser, the purchaser will not be held responsible for any deficiency. The lender can only recover the property and the proceeds of a subsequent sale. The purchaser does not pay any deficit between the sale proceeds and the outstanding loan balance

Bankruptcy exclusion: no amount of cancelled debt is included in a taxpayer's gross income by reason of a discharge of indebtedness (in whole or in part) in a bankruptcy proceeding

Capital gains: gain from the disposition or exchange of a capital asset

Capital loss: loss from the disposition or exchange of a capital asset

Carryforward: the act of applying a loss or credit from a current year to a later year

Insolvency exclusion: a taxpayer may exclude from income a discharge of indebtedness that occurs while the taxpayer is insolvent (but not involved in bankruptcy proceedings) up to the amount by which he or she is insolvent

Insolvent: there is an excess of liabilities over the FMV of assets, determined on the basis of the taxpayer's assets and liabilities immediately before the discharge

IRC §121: the code section that states that a taxpayer can exclude up to $250,000 of the gain ($500,000 for married filing joint) on the sale of a house if the house is used as the taxpayer's primary residence for two of the past five years, among other requirements

Nonrecourse debt: the lender only has claim to the assets securing the debt

Ordering rule: if only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged that exceeds the portion of the debt that is not qualified principal residence indebtedness

Personal residence: a home of an individual. It is the place to which an individual plans to return as a home after temporary absences

Qualified principal residence indebtedness: limited to $2 million or $1 million on a separate return, whereas acquisition indebtedness for purposes of the mortgage interest deduction is limited to $1 million or $500,000 on a separate return, and applies solely to a taxpayer's principal residence, and not a second home

Recapture: Inclusion of depreciation deducted in previous years in this year's taxable income

Recourse debt: the lender has recourse to assets of the borrower other than solely the assets securing the loan

Short sale: the lender and creditor agree to let a third party purchase the property for less than the loan balance, and the lender agrees to cancel the balance of the debt

INDEX

CANCELLATION OF DEBT: CONFORMITY, SHORT SALES, AND MORE
Course description and study guide

Course objectives: The purpose of this course is to provide a discussion of cancellation of debt. Topics discussed include: discharge of debt, recourse and nonrecourse debt, foreclosures and short sales, exclusion from income — IRS §108, reduction of tax attributes, property converted from personal to business use, or vice versa, using IRC §121 in a foreclosure, reporting the COD, and COD income from flow-through entities.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

Recommended CPE Hours: CPAs/PAs — 2 Tax
EAs — 2 Federal Tax
CRTPs — 2 Federal Tax

Level: Basic

Prerequisite: None

Advanced Preparation: None

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, Inc. (Registry ID: 104931)

Expiration Date: May 2016*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

- Delinquent client fees
- The Two-step approach to recourse debt
- The insolvency exclusion

Learning Objectives:

After completing this course, you will be able to:

- Determine the concept and characteristics of discharge of debt
- Identify the provisions in IRC §108 that allow a taxpayer to exclude COD income
- Identify characteristics of an exclusion for cancellation of student loans
- Recall exclusions involving bankruptcy, insolvency, or farm indebtedness provisions
- Determine calculations regarding gain or loss when a nonrecourse debt is cancelled in a foreclosure or short sale
- Identify exclusions of COD income under IRC §108(a) for a partner

After studying the materials, please answer exam questions 1-10.

Evaluation Form

Program title: _________________

If applicable, program instructor: ____

Program date: ___________ Participant name (optional):_________________________

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest.

1. Were the stated learning objectives met? ____________________________________

2. If applicable, were prerequisite requirements appropriate? ______________________

3. Were program materials accurate? ____

4. Were program materials relevant and did they contribute to the achievement of the learning objectives? _______

5. Was the time allotted to the learning activity appropriate? ______________________

6. If applicable, were the individual instructors effective? ________________________

7. Were the facilities and/or technological equipment appropriate? _________________

8. Were the handout and/or advance preparation materials satisfactory? _____________

9. Were the audio and visual materials effective? _______________________________

10. IRS Course Number (if applicable): ______________________________________

11. TTP Number: ____

12. Date course completed: ____

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***Phone:* (714) 776-7850 • *Fax:* (714) 776-9906 • *Web site:* http://www.caltax.com**

SpidellPublishing*Inc.*

Examination for Spidell's Cancellation of Debt: Conformity, Short Sales, and More

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (7 of 10) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. The concept of discharge of debt is characterized by which of the following?
   - **a)** The Tax Code defines a discharge of debt as release from indebtedness in whole or in part
   - **b)** A debt may not be discharged when a lender forecloses on property
   - **c)** The amount of debt forgiven does not include any amount forgiven that would have given rise to a deduction
   - **d)** In the case of an accrual-basis taxpayer that previously deducted the interest or a portion of it, the amount previously deducted is not included in income in the year of discharge

2. For nonrecourse debt, which of the following is correct?
   - **a)** The only calculation involved when the nonrecourse debt is canceled in a foreclosure or short sale is the amount of possible gain or loss on the sale
   - **b)** When calculating gain or loss in a foreclosure or short sale, the amount realized is the lesser of the principal amount of the debt or the FMV of the property
   - **c)** If property subject to a nonrecourse debt is conveyed to the creditor and the nonrecourse debt exceeds the FMV of the property, the difference will be treated as COD income
   - **d)** When the nonrecourse obligation exceeds the fair market value of the property, the fair market value must be included in the calculation when determining the amount realized in discharging the obligation

3. IRC §108 contains provisions that allow a taxpayer to exclude COD income, beginning with which exclusion?
   - **a)** Insolvency
   - **b)** Bankruptcy
   - **c)** Qualified principal residence indebtedness
   - **d)** Qualified real property business indebtedness

4. For taxable years beginning on or after January 1, 2009, and before January 1, 2014, California conforms to IRC §108(a)(1)(E), except that the maximum COD exclusion is limited to _______.
   - **a)** $500,000
   - **b)** $800,000
   - **c)** $250,000
   - **d)** $400,000

5. Which of the following statements is **not** correct regarding insolvency?
   - **a)** When determining assets, cash, stocks and bonds, other investment assets, personal residences, autos, and household goods are included
   - **b)** Liabilities include contingent liabilities or liabilities that the taxpayer has guaranteed if it is more likely than not that the taxpayer will be called upon to pay them
   - **c)** If the taxpayer has no tax attributes, COD still applies
   - **d)** When determining insolvency, assets do not include those that are exempt from creditors' claims under state law

6. The exclusion for cancellation of student loans may be correctly characterized by which of the following?
   - **a)** An individual's gross income includes forgiveness of loans made by tax-exempt charitable organizations if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans, and the student is not employed by the lender organization
   - **b)** The discharge of student loans does not give rise to discharge of indebtedness if the discharge is pursuant to a provision in the loan agreement under which all or part of the student loan is forgiven, so long as the student works for a certain period of time in certain professions
   - **c)** California partially conforms to the exclusion for student loan forgiveness
   - **d)** The provision that the discharge of student loans will not give rise to discharge of indebtedness applies to a law school's loan repayment assistance program that forgives all or part of a student's debt if the graduate completes a period of employment at a law firm

7. In the case of an exclusion involving the bankruptcy, insolvency, or farm indebtedness provisions, specific tax attributes of the taxpayer must be reduced by the amount excluded from income. The taxpayer must reduce tax attributes beginning with _______.
   - **a)** Carryovers of the general business credit
   - **b)** Capital losses and carryovers
   - **c)** NOLs and carryovers
   - **d)** The minimum tax credit available under IRC §53(b)

8. In the case of basis reductions required because COD income is excluded under the bankruptcy or insolvency provisions, basis is reduced beginning with which choice below?
   - **a)** Property not used in a trade or business
   - **b)** Personal property used in a trade or business other than inventory, accounts receivable, and notes receivable that secured the indebtedness immediately before the discharge
   - **c)** Inventory, accounts receivable, and real property held for sale to customers
   - **d)** Real property used in a trade or business held for investment that secured the debt immediately before the discharge, not including real property held as inventory for sale to customers

9. Under IRC §121, a taxpayer can exclude up to _______ of the gain on the sale of a house if the house is used as the taxpayer's primary residence for two of the past five years, among other requirements.
   - **a)** $100,000
   - **b)** $250,000
   - **c)** $500,000
   - **d)** $265,000

10. Which of the following choices does not accurately complete this sentence: A partner may exclude COD income under IRC §108(a) only if _______.
    - **a)** The partner is insolvent
    - **b)** Qualified farm indebtedness is cancelled
    - **c)** Debt is qualified real property business indebtedness, the partner is a C corporation, and the partner elects to reduce basis in depreciable real property
    - **d)** The bankruptcy exclusion applies