

STRATEGIC

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Strategic Integrated Planning

March 1, 2010

Subject: Strategic Law Group's "STRATEGIC INSIGHTS"

Cancellation of Indebtedness Income ("COD") in Dispositions of Distressed Properties

Recently much has been written about the supposed benefits associated with so-called "short sales" of underwater investment properties as an alternative to a foreclosure by the lender. While much of the literature mentions the "hidden" tax costs associated with a short sale, there is a great deal of misinformation as to exactly what those hidden costs are and how they should be calculated. This alert will briefly explain the calculations required in order to determine the tax consequences of a short sale, and provide several helpful examples (transactions involving a principal residence are subject to special rules, and are not discussed in this alert). But first, there are a few critical terms you need to understand.

What is a Short Sale? In its simplest form a short sale is a negotiated sale of a property in which the holder of the 1st mortgage agrees to take less than the amount owed at the closing in full satisfaction of the debt.

What is COD Income and How is it Taxed? Cancellation of indebtedness income (usually referred to as "COD income") results from settling a debt for less than the face amount. So if a lender that is owed \$500,000 agrees to accept \$400,000 in full satisfaction of its loan, the borrower would have \$100,000 of COD income that would generally be taxed at ordinary income tax rates.

What is "Recourse" Debt? In the real estate context, recourse debt is debt that is typically secured by property but on which the borrower has personal liability for a deficiency should the lender foreclose and realize less than the full amount of the debt on the sale of the property. In California and most other states loans taken out to purchase investment property (as opposed to a principal residence) are typically recourse loans.

What is "Non-Recourse" Debt? Non-recourse debt is debt on which the lender's sole recourse is to foreclose on the property securing the loan, with no right to pursue the borrower for any resulting deficiency. In California purchase money loans used to acquire a principal residence are non-recourse by statute.

What are the Tax Consequences of a Short Sale of Underwater Investment Property Encumbered by a Recourse First Mortgage? In a short sale of property encumbered by a recourse loan, the borrower is deemed to have sold the property for an amount equal to its fair market value, and the shortfall to the lender is treated as COD income to the borrower.

Example - "A" owes \$800,000 on a recourse loan secured by Blackacre, an investment property located in California. "A" purchased Blackacre for \$1,000,000, and has claimed \$100,000 in depreciation deductions on the straight-line method. "A" negotiates a short sale of Blackacre to "B" for \$600,000.

Result - "A" has a capital loss of \$300,000 [adjusted basis of \$900,000 less deemed sale proceeds of \$600,000] and has \$200,000 in COD income [\$800,000 less \$600,000]. Unfortunately for "A", under most circumstances he can only use \$3,000 of that capital loss to offset the \$200,000 ordinary income recognized in the year of sale.

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Does a Foreclosure Sale Produce a Different Result than a Short Sale? If a borrower permits the property secured by a recourse loan to go to foreclosure, the result will depend on the state in which the property is located and the manner in which the lender chooses to foreclose. If the property is located in California and the lender chooses (as almost all lenders do) to exercise the power of sale in the deed of trust, the so-called “one action” rule effectively converts the loan into a non-recourse loan, since the lender can no longer pursue a deficiency judgment against the borrower. As a consequence, the borrower is deemed to have sold the property for the face amount of the loan, rather than its FMV, and no COD income is generated.

Example - Assume the same facts as above, but the lender forecloses under the power of sale in its deed of trust.

Result - “A” has a capital loss of \$100,000 on the foreclosure of Blackacre [adjusted basis of \$900,000 less deemed sale proceeds of \$800,000] and no COD income. By permitting the lender to foreclose rather than doing a short sale, the borrower has eliminated \$200,000 in COD income at a “cost” of reducing his capital loss by an equivalent amount.

The “Insolvency” Exception. The Internal Revenue Code provides limited relief from the impact of the COD rules in circumstances where the borrower is deemed to be insolvent immediately before the disposition of an underwater property by short sale or foreclosure. The application of the insolvency exception is complicated, but the rationale for the rule is fairly straight forward, namely, that a taxpayer should only recognize COD income where the discharge of a debt results in an increase in the taxpayer’s net worth. The following example illustrates how the rule would work in a typical situation.

Example - “B” owes \$1,200,000 on a recourse loan secured by Whiteacre, an investment property located in California. “B” purchased Whiteacre for \$1,000,000, and has claimed \$300,000 in depreciation deductions on the straight-line method. “B” negotiates a short sale of Whiteacre to “C” for \$800,000. Immediately before the short sale closes “B” was insolvent by \$300,000 and after the sale has a net worth of \$100,000 [\$300,000 less the \$400,000 reduction in “B’s” liabilities resulting from the short sale]

Result – “B” has \$400,000 in COD income [\$1,200,000 less \$800,000] but will only have to pay ordinary income tax on \$100,000 of the COD income, the amount by which the short sale made “B” solvent. “B” also has a \$100,000 capital gain [\$800,000 deemed sale price less \$700,000 basis].