

SHORT SALES & FORECLOSURES



HANDLING IRS 1099 INCOME

Confused about an IRS Form 1099 in a short sale or foreclosure?

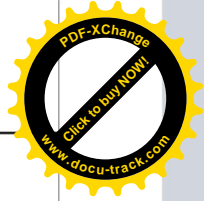
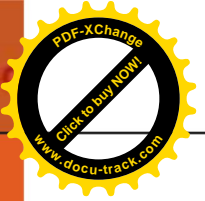
BY R. LAWRENCE (LARRY) HEINKEL, ESQ.

Chances are that a majority of your transactions still deal with foreclosures or short sales. As difficult as these transactions can be for all parties involved, the process is often compounded by the issuance of a Form 1099, which reports to the Internal Revenue Service (IRS) the amount of indebtedness that the lender is writing off or forgiving. Customers are confused about the way they should treat this form. While it's important to refer them to an attorney for advice on this topic, educating yourself on the process is vital.

What a Form 1099 Means

When a property is foreclosed or a short sale closed, the net sale price is applied toward the debt, but it doesn't satisfy the entire obligation. The rest is frequently forgiven and written off. The number reported on the Form 1099 is the amount of the loan that was not repaid by your customer, not the total amount of debt on the property.

For example: Your customer owes \$500,000 on a house worth only \$350,000.



If the house is foreclosed (or short sold) for \$350,000, that amount is applied to the \$500,000 debt but there is still a \$150,000 deficiency. The lender can sue your customer to collect this deficiency or write it off and issue him or her a Form 1099 for the \$150,000.

Where the Confusion Sets In

What many people fail to realize is that a foreclosure or short sale is not a single transaction but two transactions. The first part is a “sale or exchange” of the subject real property for a sale price equal to the property’s fair market value. The second is forgiveness of the debt that exceeds the property’s fair market value. These two transactions must be analyzed separately.

The first part will typically be (1) a tax-free gain on the sale of the debtor’s principal residence under Section 121 of the Tax Code, (2) a tax loss because the property’s adjusted tax basis exceeds its fair market value or (3) a tax gain (not gains) because the property’s fair market value exceeds its adjusted tax basis.

For example, assume there is a short sale where the seller owes \$500,000 on rental property worth \$350,000, which has a tax basis of \$300,000. Since the property is sold for \$350,000, the lender has accepted a \$350,000 payment on the \$500,000 debt, leaving a \$150,000 balance owed. In effect, the seller sold its rental property for \$350,000, and because the tax basis is only \$300,000, the seller has realized a \$50,000 gain and is taxed in the same manner as if the property had been sold to an unrelated party for \$350,000. In the second part of the transaction, the lender writes off the unpaid \$150,000 debt and issues the debtor a Form 1099 for that amount. This write-off is analyzed in the following section.

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General Rule of Forgiveness

Generally, debt that is written off or forgiven by a lender constitutes ordinary taxable income to the debtor. To avoid recognizing taxable income, your customer must find relief—an exception to the general rule. Here are exceptions that may be available to the debtor (use IRS Form 982 to report the exception):

1. Debt Forgiveness on Principal Residence

The Mortgage Debt Relief Act of 2007 allows nonrecognition to certain debt that was forgiven on your customer’s principal residence. To qualify, all the following must be met:

- The debt must be forgiven during the period 2007 through 2012.
- The property must be the customer’s principal residence.
- The exception must not exceed the \$2 million cap (\$1 million for singles) on forgiven debt.
- The write-off must be done because of a decline in the home’s value and/or the taxpayer’s financial condition, which means from loan modification or foreclosure.
- The debt must have been secured by the home (not unsecured loans); must have been used to buy, build or substantially improve the principal residence; or must be refinance debt used for such purposes. Second mortgages taken out to pay debts, take vacations, etc., do not qualify for this exclusion.

2. Insolvency Exception

The debtor can avoid taxable income on the forgiven debt to the extent that he or she is insolvent. “Solvency” is measured by subtracting the amount of all debt from the fair market value of all assets. Assets include those that are both

exempt (homestead equity, IRAs, life insurance policies) and nonexempt. This exclusion is limited to the extent of the insolvency.

Continuing with the debtor who has \$150,000 of 1099 income: assume he has \$100,000 of other debt, IRAs worth \$40,000 and other miscellaneous assets of \$10,000.

The assets total \$50,000, and the debts total \$250,000, so he has a net worth of negative \$200,000. The forgiven debt (\$150,000) is excluded to the extent of the insolvency (\$250,000) so the entire amount is tax free.

3. Bankruptcy Exception

Income recognition can also be avoided if the debt obligation were discharged in a bankruptcy. Many debtors don’t qualify for exclusion under the insolvency exception due to the existence of exempt assets that render them solvent. So they must file bankruptcy to avoid income recognition while keeping the exempt assets.

If a debtor, solvent due to the existence of exempt assets, wants to file bankruptcy to avoid income recognition, does the bankruptcy filing have to precede the Form 1099 issuance? It’s presently unclear. To be safe, the prudent debtor should file for bankruptcy protection prior to the Form 1099 issuance.

Fortunately, many people don’t have to fear forgiveness-of-debt income because they’re insolvent and/or they file bankruptcy to discharge their obligations under the loans.

Only customers who have substantial exempt assets and do not file bankruptcy before the Form 1099 is issued or those who have substantial built-in tax gains in their surrendered properties have serious concerns.

This article is not to be considered the rendering of legal advice. Because each person’s situation is different, your customer should seek competent legal help in this area of law. ○

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