Chapter 3: Financial Distress

3

Corrections were made to this workbook through January of 2014. No subsequent modifications were made.

CANCELED DEBT

In 2008, the nation's economic situation stalled into one of the worst downturns since the Great Depression. The housing market collapsed and many homeowners were left with homes worth less than what was owed on them. Layoffs and terminations were rampant and many homes went into foreclosure. With the stalled economy, many individuals were unable to meet their debt obligations, which, in some cases, caused lenders to cancel debt.

Borrowing money from a lender does not result in taxable income to the borrower at the time of the loan because there is an offsetting obligation to repay the debt. However, if a lender cancels or forgives all or part of a loan, then the canceled amount may have to be included in taxable income by the taxpayer. Including canceled debt in taxable income can be difficult for a taxpayer who is already struggling financially. This chapter highlights some of the exceptions to including canceled debt in ordinary income.

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RECOURSE VERSUS NONRECOURSE DEBT

Debt for which a taxpayer is **personally liable** is referred to as "recourse debt." All other debt is "nonrecourse debt."

If **recourse debt is canceled,** the amount of canceled debt is **generally ordinary income** to the taxpayer. In contrast, if **nonrecourse debt is canceled,** the canceled debt is **generally not ordinary income** unless the collateral is retained and the lender provides a discount for early payment or modifies the loan, reducing the principal owed.

Canceled debt that meets the requirements for any of the following **exclusions** from gross income is **not taxable.**[1]

- Debts discharged in a Title 11 bankruptcy proceeding
- Debts discharged while the taxpayer is insolvent
- Qualified farm indebtedness
- Qualified real property business indebtedness (QRPBI) of a taxpayer other than a C corporation
- Qualified principal residence indebtedness (QPRI) discharged prior to January 1, 2014

Each of these exclusions is discussed in this chapter.

1. *Tax Topic 431 — Canceled Debt — Is It Taxable or Not?* [www.irs.gov/taxtopics/tc431.html] Accessed on Jul. 10, 2013.

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Canceled Debt Exclusions

Exclusion	Requirements	Election	Limit	Reporting	Reduction of Tax Attributes
Bankruptcy	Varies depending on which chapter is filed		Total amount canceled	Form 982, line 1a	Reduce basis of personal use property
Insolvency	Immediately before cancellation to the extent total of all liabilities was more than FMV of all assets		Extent of insolvency	Form 982, line 1b	
Qualified farm indebtedness	Debt incurred directly in connection with operation of trade or business of farming; 50% or more of total gross receipts for 3 preceding years were from trade or business of farming; cancellation made by a qualified person not related to the taxpayer, from whom the taxpayer acquired the property, or a person who receives a fee from taxpayer's investment in property		Sum of adjusted tax attributes and total adjusted basis of qualified property held at beginning of tax year	Form 982, line 1c	Reduce basis of qualified property in the following order: depreciable qualified property, land that is qualified property and used in farming business, and other qualified property
QRPBI	Incurred in connection with real property used in trade or business; secured by real property; incurred before 1993	Required	Outstanding principal amount of qualified real property business debt over FMV of business real property securing debt	Form 982, line 1d	Reduce basis of depreciable real property by amount canceled (not below $0)
QPRI	Mortgage to buy, build, or substantially improve main home or refinance up to the amount of the old mortgage principal		$2 million for MFJ, $1 million for MFS	Form 982, line 1e	Reduce basis by amount of canceled QPRI excluded (but not below $0)

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Issuance of Form 1099-C

Generally, if a recourse debt owed by the taxpayer is forgiven or satisfied for less than the full amount owed, the debt is considered canceled to the extent of the indebtedness forgiven or unpaid. The lender must issue a Form 1099-C, *Cancellation of Debt,* upon the cancellation of debt of $600 or more. This is taxable income for the taxpayer unless an exception applies that allows the taxpayer to exclude the canceled debt from income.

> **Example 1.** Jack owed $10,000 to Jill, who is a lender by trade. Jack paid $8,000 in satisfaction of the entire debt, which Jill agreed to accept. Jack has $2,000 of canceled debt and, because this amount is greater than $600, Jill is required to send Jack a Form 1099-C reflecting the $2,000 in canceled debt.

> **Example 2.** Jack owed $10,000 to Jill. Jack and Jill agreed that Jack would provide Jill with hill-climbing services (instead of money) in full satisfaction of the debt. Jack does not have cancellation of indebtedness income. Instead, he has income from services.

Entities required to submit a Form 1099-C include the following.

- Federal government agencies
- Financial institutions
- Credit unions
- Any organization whose significant trade or business is the lending of money

Even if the taxpayer does not receive a Form 1099-C, the canceled debt must be reported as gross income on the tax return unless an exception applies. For debts of $10,000 or more that involve debtors who are jointly and severally liable, the lender must report the entire amount of the canceled debt on each debtor's Form 1099-C.

Form 1099-C, box 2, shows the amount of debt canceled that generally must be reported as ordinary income by the taxpayer. This amount can also include interest, fees, and penalties. If interest is forgiven and included as canceled debt, the interest portion should be listed in box 3. If the interest would normally be deductible by the taxpayer, it does not have to be included in gross income. If the interest would not be deductible, the entire amount reported in box 2 should be included in the taxpayer's gross income.

Beginning in 2013, codes for identifying the type of event that led to the issuance of Form 1099-C are required. The following codes are used to report the identifiable event in box 6.[2]

A. Bankruptcy

B. Other judicial debt relief used to identify cancellation of debt as a result of receivership, foreclosure, or similar federal or state court proceedings other than bankruptcy

C. Statute of limitations or expiration of the deficiency period (In the case of the expiration of a statute of limitations, an identifiable event occurs only if and when the affirmative defense of the statute of limitations is upheld in a final judgment or decision in a judicial proceeding, and the period for appealing the judgment or decision has expired.)

D. Foreclosure

E. Debt relief from probate or similar proceedings

F. Cancellation of debt as a result of an agreement between the creditor and the debtor to cancel the debt at less than full consideration

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2. Instructions for Forms 1099-A and 1099-C.

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G. A discharge of debt because of a decision or a defined policy to discontinue collection activity and cancel the debt

H. Expiration of a nonpayment testing period (This code is used to indicate that the creditor has not received a payment on the debt during a testing period. The testing period is a 36-month period ending on December 31, increased by the number of months the creditor was prevented from engaging in collection activity by a stay in bankruptcy or similar bar under state or local law.)

I. Other actual discharge before an identifiable event; used to identify an actual cancellation of debt that occurs before any of the identifiable events described above

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city or town, province or state, 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 2013 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, province or state, 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

BANKRUPTCY

In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).[3] This legislation made numerous changes to bankruptcy laws and tightened restrictions on debtors seeking bankruptcy protection.

A bankruptcy estate is created at the commencement of a bankruptcy case. Generally, the estate includes all of the legal and equitable interests in property owned by the debtor, but federal bankruptcy law and state laws can determine which assets become part of the estate and which are excluded or exempted. Exempted and abandoned property is initially included in the bankruptcy estate but is later removed from the estate.

The transfer of assets from the debtor to the bankruptcy estate is not a taxable event. The estate assumes the same basis and character of the transferred assets and generally accounts for the property in the same manner as the debtor. Likewise, when the bankruptcy estate is terminated or dissolved, the transfer of the remaining assets back to the debtor is not treated as a disposition of property and does not result in any gain or loss, recapture, or acceleration of income or deductions.[4]

The individual taxpayer should not include any canceled debt as income on their tax return if the debt was canceled because of a bankruptcy discharge. If debt was canceled outside the bankruptcy proceeding, it should be reported as income to the individual taxpayer unless the debt is otherwise eligible for exclusion.

There are multiple types of cases under the bankruptcy code, which fall under different chapters. Following is a synopsis of each.

3. PL 109-8, 119 Stat. 23 (2005).

4. IRS Pub. 908, *Bankruptcy Tax Guide.*

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Chapter 7

Chapter 7 is a **voluntary liquidation** process for individuals, partnerships, corporations, and other business entities.[5] The debtor must meet a means test,[6] but the test does not require the debtor to be insolvent. The debtor must also have attended credit counseling, not have had a previous case dismissed for improper conduct, and not have filed a previous case within the past eight years.[7]

The result at the end of a successful Chapter 7 proceeding is the liquidation of assets and the discharge of debt. The debtor turns over all their assets to the bankruptcy court and a trustee is appointed to handle the estate. The court returns assets to the debtor that are exempt from creditors and the debtor's dischargeable debts are discharged.

Under Chapter 7, a separate bankruptcy estate is created and treated as a separate taxable entity. An employer identification number (EIN) must be obtained for the estate. The trustee (or debtor-in-possession) is responsible for filing bankruptcy estate tax returns, including Form 1041, *U.S. Income Tax Return for Estates and Trusts*. The trustee must use the EIN on all tax returns filed with the IRS.

The debtor remains liable for filing their own income tax returns and paying taxes on any income not belonging to the estate. Debtors cannot claim deductions related to the bankruptcy.

Note. An EIN for a bankruptcy estate can be obtained in the following ways.

1. Apply online at **www.irs.gov/businesses/small**
2. Call 800-829-4933 from 7 a.m. to 7 p.m. in the trustee's or debtor-in-possession's local time zone
3. Mail or fax a Form SS-4, *Application for Employer Identification Number*

Chapter 11

Chapter 11 bankruptcy is a **reorganization plan for corporations, sole proprietorships, and partnerships** to keep the business operating and to pay creditors over time. Typically, personal assets are not at risk; however, a Chapter 11 case for a sole proprietorship may involve the debtor's personal assets as well as the business assets. For a partnership debtor, the partners' personal assets may be used to repay creditors, which could force the partners to file for bankruptcy protection as well.

In Chapter 11 bankruptcy, the debtor-in-possession performs the trustee's duties, such as filing tax returns. A creditor committee is established to consult with the debtor to administer the case, operate the business, and assist in formulating a reorganization plan. The debtor files a reorganization plan, which must be approved by the court. After a waiting period, a creditor can also file a competing plan. Confirmation of the reorganization plan discharges debtors from most types of prepetition debts. At the end of the bankruptcy case, some or all of the debts will be repaid.

Under Chapter 11, a separate bankruptcy estate is created and treated as a separate taxable entity. An EIN must be obtained. The bankruptcy trustee files the estate tax returns and pays taxes owed by the estate.

Note. A debtor-in-possession may be compensated by the estate for managing a trade or business that the debtor conducted before the bankruptcy filing. The payments received by the debtor for this service should be reported as miscellaneous income. The estate is entitled to deduct the payments as administrative expenses.

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5. 11 USC §§101(41) and 109(b).

6. BAPCPA put in place a means test to determine whether abuse will be presumed. This test projects the debtor's monthly income minus expenses for a 5-year period. If the debtor's current net monthly income exceeds the median income for the debtor's state, the debtor is subject to the means test. The means test is used to determine whether the debtor's Chapter 7 case should be dismissed or converted to a Chapter 13 proceeding based on the finding of abuse by the bankruptcy court. The median income chart can be found at www.justice.gov/ust/eo/bapcpa/20130401/bci_data/median_income_table.htm.

7. 11 USC §727(a)(8-9).

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Chapter 12

Chapter 12 bankruptcy protection is only for **family farmers and fishermen** with regular annual income from the business activity and who meet other specific qualifying criteria. The debtor must file a schedule of assets and liabilities, schedule of current income and expenditures, schedule of executor contracts and unexpired leases, and a statement of financial affairs.

A meeting of creditors is held between 20 and 35 days after filing. The debtor must attend this meeting and answer questions regarding their finances and proposed repayment plan. Unsecured creditors must file claims within 90 days after the scheduled creditors' meeting.

Within 45 days after the reorganization plan is filed, the court determines whether the plan is feasible and whether it can be confirmed. If the court confirms the plan, the Chapter 12 trustee distributes funds received in accordance with the terms of the plan. If it is not approved, the debtor may file a modified plan or the debtor may convert the case to a Chapter 7 liquidation.

The reorganization lasts between three and five years (but no longer than five years).[8] However, secured creditors can sometimes be paid over more than five years. For instance, if an equipment loan had an original repayment schedule that was longer than five years, that repayment schedule continues. It is only the portion of the payment in arrears that must be corrected during the reorganization plan period.[9]

At the conclusion, the debts will have been adjusted to reflect debt flow while protecting the family's needs. However, all unsecured creditors must receive at least as much as they would have received under a Chapter 7 liquidation. Secured creditors must be paid at least as much as the value of the collateral pledged for the debt.

Chapter 13

Chapter 13 bankruptcy is a **reorganization plan for individuals and sole proprietorships** that allows for repayment of all or part of the debts through regular installment payments over three to five years. If the debtor's monthly income is less than the applicable state median, the repayment period generally lasts only three years. If the debtor's monthly income is higher than the applicable state median, the plan generally must be for five years.

To be eligible for Chapter 13, the debtor must participate in credit counseling. In addition, the individual's unsecured debts cannot exceed certain limits, which in 2013 are $1,149,525 for secured debt and $383,175 for unsecured debt.[10]

Approximately 20 to 50 days after the Chapter 13 bankruptcy petition is filed, the trustee holds a creditors' meeting in which the debtor must answer creditors' questions regarding the reorganization plan. At the meeting, issues regarding the plan can be reviewed and the parties can decide whether there should be a court hearing on the reorganization plan. If the plan is approved, the debtor must make regular payments in accordance with the plan. The trustee then distributes the funds to the creditors according to the terms of the plan.

At the conclusion of the bankruptcy case, some or all of the debts will be repaid. The debtor is eligible for discharge of the remaining debts as long as the debtor:

- Certifies that all domestic support obligations have been paid,
- Has not received a discharge in a prior case within a certain time period,
- Has completed an approved course in financial management, and
- Has no adversary complaint.

Under Chapter 13 cases, the bankruptcy estate is not a separate taxable entity.

> **Note.** For a more thorough description of each bankruptcy chapter and the requirements for debtors, see the 2008 *University of Illinois Federal Tax Workbook,* Chapter 13: Financial Distress. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

8. 11 USC §1222(c).
9. *In re Tognini,* 10-20157-SSM, 2011 Bankr. Lexis 2629 (Bankr. E.D.VA Jul. 6, 2011).
10. IRM 5.9.10.2.

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Tax Returns

Corporate, partnership, and individual Chapter 12 and Chapter 13 bankruptcy proceedings require the **debtor** to continue to file all income tax returns. Under Chapter 7 and Chapter 11 bankruptcies, a **separate bankruptcy estate** is created. The bankruptcy trustee is required to file the appropriate income tax returns for the bankruptcy estate.

The bankruptcy estate is entitled to deduct expenses incurred in a trade, business, or other activity and to use credits in the same way that the debtor would have used them. The estate may also deduct administrative expenses. These expenses include accounting fees, attorney fees, and court costs, which are listed on Form 1040, Schedule A, *Itemized Deductions*, as miscellaneous itemized deductions. They are not subject to the 2% floor because they would not have been incurred if the property had not been held by the bankruptcy estate.[11] If some of the expenses incurred by the bankruptcy estate are attributable to conducting a trade or business for the production of estate rents or royalties, they are deductible in determining adjusted gross income (AGI) on Form 1040, Schedule C, *Profit or Loss from Business (Sole Proprietorship)*; Schedule E, *Supplemental Income and Loss*; or Schedule F, *Profit or Loss From Farming*.

The bankruptcy estate uses Form 1041 as a **transmittal** for the return prepared on Form 1040.[12]

> **Note.** If the administrative expenses of the estate are more than the estate's AGI, the excess amount can be carried back three years and forward for seven years. This amount is treated like a net operating loss (NOL) and must first be carried back to the earliest year possible before it can be carried forward. However, this amount can only be carried to an estate's tax year. The individual debtor is not allowed to deduct the bankruptcy's administrative expenses.

Chapter 13 Statutory Filing Requirements for Prebankruptcy Periods. The bankruptcy code specifically requires Chapter 13 debtors to timely file all tax returns for tax years ending within four years of the filing of the bankruptcy petition.[13] All federal returns must be filed before the date set for the first meeting of creditors. The debtor can request that the trustee hold the meeting open for an additional 120 days to allow the debtor time to file the returns or, if later, until the date the returns are due under an IRS extension. The debtor can also request an additional 30-day extension from the bankruptcy court after notice and hearing. If the debtor fails to timely file the tax returns, the debtor's case can be dismissed or converted to a Chapter 7 bankruptcy.[14] This conversion or dismissal has been deemed mandatory if requested by a party in interest.[15]

> **Note.** In general, taxpayers are required to file tax returns. However, there are situations in which no filing obligation exists, such as a person who did not make enough money to meet the filing threshold. Bankruptcy trustees may require a tax return from the debtor. In the case of an individual who had only nontaxable income or otherwise did not meet the filing threshold, an affidavit stating the facts may be sufficient. In other instances, the debtor should be aware that there may be implications in the bankruptcy for failing to timely file a return. For example, in order for past tax obligations to be dischargeable, tax returns due at least three years before the Chapter 7 bankruptcy case is initiated must have been filed at least two years before the petition is filed.

11. IRC §67(e); IRS Pub. 908, *Bankruptcy Tax Guide.*

12. IRS Pub. 908, *Bankruptcy Tax Guide.*

13. 11 USC §1308.

14. 11 USC §1307(e).

15. See e.g,. *In re Cushing,* 401 B.R. 528 (1st Cir. BAP 2009); *In re Kuhar,* 391 B.R. 733, 739 (Bankr. E.D. Pa. 2008);

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Tax Returns Due after Bankruptcy Filing. Under all chapters of the bankruptcy code, debtors must file all applicable federal, state, and local tax returns that **become due after a case commences.** Failure to file returns (or obtain timely extensions) can result in conversion of the taxpayer's bankruptcy case from one chapter to another or dismissal of the entire case. If the debtor fails to timely file any returns, the applicable taxing authority can request that the bankruptcy court convert the case or dismiss it. If the debtor fails to file the return within 90 days of the taxing authority's request, the bankruptcy court must convert the case or dismiss it. The court's actions are not discretionary.

Chapter 11 Tax Reporting. If a Chapter 11 debtor receives Form W-2 wages and a portion of the wages would be postpetition services includible in the bankruptcy estate, the W-2 amounts must be allocated between the debtor and the estate. This includes allocation of both the wages that are reported in Form W-2, box 1, and the income tax withheld that is reported in box 2. The trustee and the debtor can agree to use a simple percentage method to allocate the amounts, but the same method must be used to allocate both the income and the tax paid. The allocation must also reflect the debtor's postpetition gross earnings.[16] All postpetition gross earnings are included in the estate and not in the debtor's gross income.

The debtor must attach a statement to their tax return stating that the return is filed subject to a Chapter 11 bankruptcy. The statement must:

- Show allocations of income and income tax withheld;
- Describe the method used to allocate these amounts; and
- List the filing date of the bankruptcy case, the court in which the case is pending, the bankruptcy court case number, and the bankruptcy estate's EIN number.[17]

The bankruptcy code does not affect the determination of what earnings are deemed wages for FICA and FUTA tax purposes.[18] The debtor's employer should continue to report all wages and withholding on Form W-2, *Wage and Tax Statement*, under the debtor's name and social security number. The debtor is not required to file a new Form W-4, *Employee's Withholding Allowance Certificate*, simply because of the bankruptcy filing. However, the debtor may need to file a new Form W-4 if they are no longer entitled to claim the same number of allowances because certain deductions or credits belong to the estate.[19] The debtor may also want to increase income tax withholding to avoid having to make estimated tax payments for the estate.[20]

With the exception of persons or entities filing Forms W-2, the trustee should provide the bankruptcy estate's EIN to all persons and entities required to file information returns pertaining to the estate's gross income, gross proceeds, or other reportable payments.[21] Because the income is the property of the estate, these individuals and entities should file all information returns using the estate's name and EIN.[22] When the bankruptcy case is closed, dismissed, or converted, the estate is no longer a separate taxable entity. The debtor should provide notice to all individuals and entities previously notified of the case to ensure that gross income, proceeds, and other reportable payments are thereafter reported to the debtor rather than the bankruptcy estate.

If the Chapter 11 bankruptcy is converted to Chapter 7, the bankruptcy estate continues to exist. Gross income, profits, and other events are reported to the estate if they relate to property of the estate. Services performed by the debtor in Chapter 7 bankruptcy, however, are not considered property of the estate.

> **Note.** The trustee must withhold income and social security taxes and file applicable returns for any wages paid.

16. IRC §31(a).
17. IRS Notice 2006-83, 2006-2 CB 596.
18. 11 USC §1115; see also IRS Notice 2006-83, 2006-2 CB 596.
19. Treas. Reg. §31.3402(f)(2)-1.
20. IRC §6654(a).
21. IRC §6109(a)(2).
22. See IRC §§6041 through 6049.

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If the debtor has self-employment (SE) income, the debtor should continue to report this income on Schedule SE, *Self-Employment Tax.* This includes the SE income earned postpetition. The debtor, of course, must pay any SE tax due.

Note. Neither the bankruptcy code nor IRC §1398 addresses the application of SE tax to postpetition earnings.

If the bankruptcy estate has gross income exceeding the threshold filing amount, then a tax return must be filed on Form 1041. The threshold amount in 2013 is $10,000 (the $3,900 personal exemption plus the $6,100 standard deduction).

Special Election in Year of Bankruptcy: IRC §1398. In general, the bankrupt debtor's tax year does not change upon filing for bankruptcy. However, debtors having nonexempt assets may elect to end the debtor's tax year as of the day before the bankruptcy filing. Taxpayers filing a Chapter 7 case have a significant tax decision about whether to make the election to close the tax year before the commencement of the bankruptcy. Generally, the election is beneficial if the taxpayer will have a tax liability for the tax year in which the bankruptcy is filed. If the taxpayer has no tax liability in the year that the bankruptcy is filed, there may be no benefit to making the election.

Making the election creates two short tax years for the debtor. The first short year ends the day before the bankruptcy filing. The second year begins with the bankruptcy filing date and ends on the bankrupt debtor's normal yearend date. If the election is not made, the full tax year applies to the debtor as usual and the debtor remains individually liable for income taxes for that year despite the bankruptcy filing. However, if the election is made, the debtor's income tax liability for the first short year is treated as a priority claim against the bankruptcy estate and can be collected from the estate if there are sufficient assets to pay the estate's debts. If the assets in the bankruptcy estate are insufficient to pay the income tax, the remaining tax liability is not dischargeable, and the tax can be collected from the debtor at a later time.

If the short-year election under IRC §1398(d)(2) is not made by the debtor, the tax attributes listed in IRC §1398(g) pass to the bankruptcy estate and are not available for use by the debtor for the tax year in which the debtor filed the bankruptcy petition. These tax attributes listed under §1398(g) include items such as net operating losses, charitable contribution carryovers, and capital loss carryovers. If the debtor makes the short-year election, these tax attributes remain with the debtor and can be used to reduce the tax liability on the short-year return for the pre-petition period. Whether the debtor should make the election depends on a number of factors unique to each debtor's bankruptcy situation, including the objectives of the debtor, the value of assets that will be relinquished to the bankruptcy estate (which may be called upon to pay part or all of the pre-petition short-year tax liability), the amount of pre-petition tax liability, and the value of any tax attributes.

If the debtor does not act to end the tax year, none of the debtor's income tax liability for the year of the bankruptcy filing can be collected from the bankruptcy estate. Likewise, if the short year is not elected, the tax attributes (including the basis of the debtor's nonexempt property) pass to the bankruptcy estate as of the beginning of the debtor's tax year.

Example 3. Rich Poore is a cash-basis taxpayer. He has $150,000 of SE income from January 1 to October 31, 2012. Rich does not have any other income for 2012. He has not made any estimated tax payments. He has an NOL carryforward from 2011 of $175,000. Due to bad investment decisions, he filed for bankruptcy under Chapter 7 on November 1, 2012. If Rich files a short-year return, the NOL carryforward of $175,000 will be available to offset the SE income. If no election is made, Rich will have income tax liability for the $150,000 of SE income that will not be offset by the NOL. Instead, the NOL will pass to the bankruptcy estate.

The debtor elects to end their tax year by filing a return on Form 1040 on or before the 15th day of the fourth full month after the end of the first tax year (i.e., the day before the filing of the bankruptcy petition).[23] To avoid delays in processing, the tax return preparer should write "Section 1398" at the top of the return.

23. IRS Pub. 908, *Bankruptcy Tax Guide.*

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Example 4. Riley files her tax returns on a calendar-year basis. She filed a Chapter 11 bankruptcy petition on June 5, 2013. Riley makes an IRC §1398 election to close her tax year at the commencement of her bankruptcy case. Riley's first tax year for 2013 runs from January 1 through June 4 (the day before the filing of the bankruptcy petition). Her second tax year for 2013 runs from June 5 through December 31. Riley is required to file her tax return for the first short tax year by October 15, 2013 (the 15th day of the fourth month after the end of the first short tax year).

An election can also be made by attaching a statement to Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*. The statement must specify that the debtor elects under IRC §1398(d)(2) to close their tax year on the day before filing the bankruptcy case.

After the election is made, the debtor must file a second return on Form 1040 by the regular due date for an income tax return. To avoid delays, the phrase "Second Short Year Return after Section 1398 Election" should be written at the top of the return.

The spouse of the debtor may join in the election to end the tax year. If the spouse joins the election, a joint return must be filed for the short year. Once the election is made, it cannot be revoked for the first short tax year. The debtor and spouse, however, can file separate returns for the second short year.

If the spouse of an individual who has filed bankruptcy also files for bankruptcy later in the same year, the spouse can make a separate §1398 election. Thus, if the spouse chose to end the tax year with the original debtor, then the spouse could have up to three short tax years. If the spouse joined the debtor in the debtor's election, the debtor can join the spouse in the spouse's election. This would result in three short tax years for both the spouse and the debtor. If the spouse did not join the debtor's short-year election, then the debtor cannot join the spouse's election because their tax years do not coincide.[24]

Example 5. Marshall and Kate Connors are calendar-year taxpayers. Marshall's Chapter 7 bankruptcy case begins on May 6, 2013, and Kate's bankruptcy case begins on October 1, 2013.

Kate can elect to end her tax year on September 30, 2013 (the day before her bankruptcy case begins). If Marshall did not elect to end his tax year on May 5, 2013, or if he elected to do so but Kate did not join in his election, Kate would have two tax years in the same calendar year. Her first 2013 tax year is January 1 through September 30, and her second tax year is October 1 through December 31.

If Marshall did not end his tax year as of May 5, 2013, he can join Kate's election to close her tax year on September 30, 2013, but only if they file a joint return for the January 1 through September 30 tax year.

If Marshall elected to end his tax year on May 5 but Kate did not join in his election, Marshall cannot join in Kate's election to end her tax year on September 30. Marshall and Kate cannot file a joint return for that short tax year because their tax years preceding September 30 are not the same.

Example 6. Jane and Brian Daily are calendar-year taxpayers. Jane's Chapter 7 bankruptcy case began on April 10, 2013, and Brian's Chapter 7 bankruptcy case began on October 3, 2013. Jane elected to close her tax year on April 9, 2013, and Brian joined in Jane's election.

If Brian also makes the election relating to his own bankruptcy case, he has three tax years for the 2013 calendar year. The first tax year is January 1 through April 9; the second is April 10 through October 2; and the third is October 3 through December 31.

Jane may join in Brian's election if they file a joint return for the second short tax year (April 10 through October 2). If she does so, she would have the same three short tax years as Brian. In addition, Jane and Brian may file a joint return for the third short tax year, but they are not required to do so.

Note. If the debtor elects to close the tax year, the debtor must **annualize taxable income** for each short year in the same manner that a change in annual accounting period is calculated. For more information on how to annualize the debtor's income and how to calculate the tax for the short tax year, see IRS Pub. 538, *Accounting Periods and Methods.*

24. Ibid.

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If a Chapter 7 or Chapter 11 individual bankruptcy case is dismissed for any reason after the election has been made, the bankruptcy estate is no longer a separate taxable entity and the debtor must file amended tax returns to replace all full- or short-year returns. The amended returns should be filed on Form 1040X, *Amended U.S. Individual Income Tax Return*, along with a short statement explaining why the amended returns are being filed. The debtor must report all income, deductions, and credits taken by the bankruptcy estate on the amended returns.

Discharge of Tax Debts[25]

The bankruptcy court may discharge the debtor from personal liability for certain tax debt. The scope of the discharge depends on the chapter under which the case was filed and the nature of the debt.

Chapter 7. For individuals in Chapter 7 bankruptcy cases, the following tax debts are **not** subject to discharge under 11 USC §523.

- Taxes entitled to eighth priority (explained later in this chapter)
- Taxes for which no return was filed
- Taxes for which a late return was filed within two years of the bankruptcy filing
- Taxes for which the debtor filed a fraudulent return or willfully attempted to evade or defeat the tax

Penalties in a Chapter 7 bankruptcy are dischargeable unless the event that gave rise to the penalty occurred within three years of the bankruptcy and the penalty relates to a tax that is not discharged.

Chapter 11. The same exceptions to discharge that apply to individuals in Chapter 7 cases also apply to individuals in Chapter 11 cases. However, different rules apply to corporations. A corporation in a Chapter 11 case may receive a broad discharge at the time the reorganization plan is confirmed, but secured and priority claims must be satisfied under the plan.

Chapter 12. Once the debtor has completed payments under a Chapter 12 plan, the court issues a discharge of all debts provided for in the plan, except for those listed in 11 USC §523.[26] In certain circumstances, a judge can issue a hardship discharge before the plan is completed.[27]

Chapter 13. A debtor who completes all payments under a Chapter 13 plan receives a broad discharge of all debts provided for by the plan. However, priority tax claims must be paid in full under the Chapter 13 plan. The following taxes are excepted from the broad Chapter 13 discharge.

- Withholding taxes for which the debtor is liable in any capacity
- Taxes for which no return was filed
- Taxes for which a return was filed late within two years before the bankruptcy petition was filed
- Taxes for which a fraudulent return was filed
- Taxes that the debtor willfully attempted to evade or defeat
- Taxes for which the IRS did not receive notice of the bankruptcy case in time to file a claim

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25. Ibid.

26. 11 USC §1228(a).

27. 11 USC §1228(b).

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Eighth Priority Taxes

Generally, certain unsecured debts are given priority in bankruptcy cases. Certain tax debts that existed before the bankruptcy case was filed are classified as eighth priority claims. The following federal taxes, if unsecured, are eighth priority taxes.[28]

- Income taxes for tax years ending on or before the date the bankruptcy petition was filed, for which a return is due (including extensions) **within three years before the date of the filing of the bankruptcy petition**
- Income taxes assessed **within 240 days before the date of filing the bankruptcy petition**
- Income taxes that were not assessed before the petition date but were assessable as of the petition date, unless these taxes were still assessable solely because no return was filed, a late return was filed within two years of the filing of the bankruptcy petition, a fraudulent return was filed, or because the debtor willfully attempted to evade or defeat the tax
- Withholding taxes for which the taxpayer is liable in any capacity
- Employer's share of employment taxes on wages, salaries, or commissions (including vacation, severance, and sick leave pay) paid as priority claims under 11 USC §507(a)(4) or for which a return is due within three years of the filing of the bankruptcy petition, including a return for which an extension of the filing date was obtained
- Excise taxes on transactions occurring before the date of filing the bankruptcy petition, for which a return, if required, is due (including extensions) within three years of the filing of the bankruptcy petition (If a return is not required, these excise taxes include only those on transactions occurring during the three years immediately before the date of filing the petition.)

Payment of Eighth Priority Taxes. The method for payment of eighth priority taxes depends on the type of bankruptcy case involved.

Chapter 7. In a Chapter 7 case, eighth priority taxes may be paid out of assets of the bankruptcy estate to the extent that assets remain after paying the claims of secured creditors and other higher priority claims of creditors.

Chapter 11. A Chapter 11 plan can provide for the payment of the taxes, with interest from the date of the plan confirmation, over a period of five years from the date of the order for bankruptcy relief. The manner of payment must not be less favorable than the most favored nonpriority claims (except for convenience claims under §1122(b) of the bankruptcy code).

Chapter 12. In a Chapter 12 case, the debtor can pay tax claims in deferred cash payments over time.

Chapter 13. In a Chapter 13 case, the debtor can pay the taxes over three years (or over five years if the court approves).

Tax Debt versus Tax Liens

A federal tax lien is a legal claim against the taxpayer's property for unpaid tax debt. The lien protects the government's interest in all property. A federal tax lien exists after:

1. The IRS assesses the taxpayer's liability,
2. The IRS sends a notice and demand for payment, and
3. The taxpayer fails to fully pay the debt in time.

A notice of federal tax lien is filed to alert creditors that the government has a lien on the taxpayer's property.

A bankruptcy discharge of income taxes wipes out the personal obligation to pay the tax. A tax lien recorded before filing for bankruptcy remains to the extent of the value of the taxpayer's equity in the property.

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28. IRS Pub. 908, *Bankruptcy Tax Guide.*

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INSOLVENCY

A taxpayer is insolvent when their total debts exceed the total fair market value (FMV) of all their assets immediately before the debt cancellation. Assets include everything owned, including property that could be excluded in bankruptcy. This includes assets that are collateral for the debt and assets that are exempt under state law and are beyond the reach of creditors.

Liabilities used to determine insolvency include the following.[29]

- Entire amount of recourse debts
- The amount of nonrecourse debt that is not in excess of the FMV of the collateral used to secure the debt
- The amount of **forgiven** nonrecourse debt in excess of the FMV of the secured property

If the taxpayer is insolvent immediately before the debt is canceled, the taxpayer can exclude from income the amount of debt canceled to the extent that they are insolvent. The taxpayer should check box 1b of Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* to exclude canceled debt from income. On line 2 of Form 982, the taxpayer includes the lesser of either the amount of debt canceled or the amount by which the taxpayer was insolvent immediately before the cancellation. Form 982 must be attached to the taxpayer's income tax return.

> **Note.** The taxpayer can elect to apply the insolvency exclusion instead of the QPRI exclusion. This might be more advantageous to taxpayers who are insolvent and who refinance their mortgage to pay debts unrelated to the principal residence.

Example 7. Barry Bondsman had $15,000 in credit card debt canceled. San Francisco Giant Bank sent him a Form 1099-C to report the $15,000 of canceled debt income. Barry's liabilities before the cancellation totaled $100,000. The FMV of his assets is only $45,000. Barry's liabilities are $55,000 more than his assets ($100,000 – $45,000), so he is insolvent in the amount of $55,000.

Barry is insolvent in a greater amount than the credit card debt canceled, so he can exclude the entire $15,000. Barry checks the box on Form 982, line 1b. On line 2, he includes the $15,000 canceled debt because it is less than the amount by which he is insolvent. Barry does not include the $15,000 as income on his Form 1040.

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
Barry Bondsman	777-66-6677

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	15,000
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 ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in

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29. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals).*

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Example 8. Evan Rodriquez had credit card debt that was canceled. Evan received a Form 1099-C from Ranger Card Company, showing that $20,000 of debt was canceled. Evan's liabilities before the cancellation totaled $62,500. The FMV of his assets was only $50,000. Evan's assets were $12,500 ($62,500 − $50,000) less than his liabilities, so he is insolvent in the amount of $12,500. The amount of his canceled debt from Ranger Card Company is more than the amount by which he is insolvent; therefore, he can only exclude $12,500 of the $20,000 canceled debt from income.

Evan checks the box on Form 982, line 1b. On line 2, he enters $12,500 because his insolvency is less than the amount of debt canceled. He includes the remaining $7,500 ($20,000 canceled debt − $12,500 amount insolvent) as income on Form 1040, line 21.

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
Evan Rodriquez	**333-33-1234**

Part I **General Information** (see instructions)

DRAFT AS OF May 16, 2013

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	12,500
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

Reduction of Tax Attributes. You must attach a description of any transactions resulting in the reduction in

...

not attach, any payment. Also, please use **Form 1040-V.**	19	Unemployment compensation	19	
	20a	Social security benefits 20a b Taxable amount	20b	
	21	Other income. List type and amount **cancellation of debt**	21	7,500
	22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	
	23	Educator expenses 23		

Note. The insolvency worksheet in IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*, assists the taxpayer in determining whether they were insolvent immediately before the debt was canceled.

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QUALIFIED FARM INDEBTEDNESS

Canceled debt is not included in the income of the taxpayer to the extent that it is qualified farm indebtedness (QFI). In order to qualify for the QFI exclusion, three primary requirements must be met.[30]

1. The discharged debt must have been incurred directly in connection with the operation by the taxpayer of the trade or business of farming.
2. At least 50% of the aggregate gross receipts of the taxpayer for the three tax years preceding the tax year in which the discharge of indebtedness occurs must be attributable to the trade or business of farming.
3. The debt must be discharged either by a federal, state, or local government or agency, or by a person who is actively and regularly engaged in the business of lending money and who is independent of the taxpayer.

In order to qualify as independent under the third requirement, the lender cannot be a member of the taxpayer's family, the seller of the property financed by the loan (or a relative of such a person), or a person who receives a commission from the taxpayer's investment in the property (or a relative of such person).

The amount the taxpayer can exclude from income as a result of the discharge of QFI cannot exceed the sum of the following items.[31]

- The adjusted tax attributes of the taxpayer
- The aggregate adjusted bases of qualified property held by the taxpayer at the beginning of the tax year following the tax year in which the discharge occurs

QFI may not be used before other exclusions. If the canceled debt qualifies for the bankruptcy exclusion, that exclusion must be applied first. If the debt qualifies for the insolvency exclusion, that exclusion must be applied before the QFI exclusion. The tax attributes are the same under QFI but only the basis of farm property is adjusted.

QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS

Taxpayers can elect to exclude canceled qualified real property business indebtedness (QRPBI) from income. This is debt that meets the following requirements.[32]

1. It was incurred in connection with real property used in a trade or business.
2. It is secured by real property.
3. It was either:
   a. Incurred or assumed before 1993;
   b. Qualified acquisition indebtedness, which is debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property that is used in a trade or business and that is security for the debt; or
   c. Incurred to refinance QRPBI (but only to the extent that the original debt is refinanced).
4. An election to treat the debt as QRPBI is made.

30. IRC §108(g).
31. IRC §108(g)(3).
32. IRC §108(c)(3).

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The amount of canceled QRPBI is limited to the amount (if any) of the outstanding principal of the QRPBI (immediately before the cancellation), that exceeds the FMV of the property securing the debt, reduced by the outstanding principal amount of any other QRPBI secured by that property.[33]

In addition, the amount of QRPBI that can be excluded from income cannot exceed the aggregate adjusted basis of depreciable real property held immediately before the cancellation. When figuring this overall limit, the adjusted basis of the depreciable real property is determined after any reductions in basis required because of the exclusion of debt canceled under the bankruptcy, insolvency, or QFI exclusions.

The election to treat the debt as QRPBI must be made on a timely filed (including extensions) federal income tax return for the tax year in which the discharge occurs. It can be revoked only with the IRS's consent. The taxpayer should make the election by filing Form 982 and checking the box on line 1d.

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**

DRAFT AS OF May 16, 2013

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 ...

Note. If QRPBI is canceled in a Chapter 11 bankruptcy, the bankruptcy exclusion must be used first. If the QRPBI income could be excluded under the insolvency exclusion, then the insolvency exclusion must be used before the QRPBI election.

33. IRC §108(c)(2).

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QUALIFIED PRINCIPAL RESIDENCE INDEBTEDNESS

The qualified principal residence indebtedness (QPRI) exclusion, enacted by the Mortgage Forgiveness Debt Relief Act of 2007, applies to cancellation of debt used to buy, build, or substantially improve the taxpayer's principal residence, or to refinance debt incurred for those purposes. To be eligible for the exclusion, the debt must be secured by the residence.[34] This exclusion was **extended through 2013** by the American Taxpayer Relief Act of 2012.

Canceled debt for a taxpayer's principal residence can be excluded from income if it is QPRI. The taxpayer may exclude a maximum of $2 million as QPRI. If the taxpayer is married filing separately, the maximum exclusion is $1 million.[35] The exclusion only applies to cancellations of debt related to a decline in the value of the home or to the taxpayer's financial condition.

If the mortgage was refinanced, only the amount of the mortgage immediately before the refinancing qualifies as QPRI. If a loan was taken out for a home mortgage and to finance additional purchases or payments, such as paying down credit card debt, then the exclusion only applies to the portion of the loan that qualifies as QPRI.

The taxpayer must complete Form 982 to report the forgiveness of QPRI. In the event that there is a foreclosure or other loss of the home, only lines 1e and 2 of this form should be completed.

If the taxpayer retained ownership in the home and modified the mortgage terms, which resulted in the forgiveness of QPRI, then the taxpayer should complete Form 982, lines 1e, 2, and 10b. In this situation, the taxpayer must reduce the basis in the home by the amount of the QPRI excluded from income. This is documented on line 10b of Form 982. The basis cannot be reduced below zero.

Note. If the taxpayer filed Chapter 11 bankruptcy and the debt was canceled as part of the bankruptcy, then the taxpayer must apply the bankruptcy exclusion rather than the QPRI exclusion. If the taxpayer was insolvent immediately before the debt cancellation, then the taxpayer may elect to take the insolvency exclusion instead. In this situation, the taxpayer should check the box on Form 982, line 1b rather than the box on line 1e.

Example 9. Rian Halle purchased a house in 2007 for $150,000. He made a 20% down payment and financed the remaining $120,000 with Fast Feet Bank. In 2012, Rian fell behind on his mortgage. In 2013, the bank foreclosed on the property. At that time, the value of Rian's house had decreased to $90,000 because he had spent all his time running marathons rather than maintaining the house. Rian still owed Fast Feet Bank $100,000 on the mortgage.

The house was sold in 2013 for its full $90,000 FMV. Rian was still personally liable for $10,000 on the loan. However, the bank forgave the debt in excess of the FMV of the house ($10,000).

Rian must check the box on line 1e of Form 982. On line 2, he should enter the $10,000 of canceled debt. He does not include the $10,000 as income on his Form 1040.

Rian also has a $60,000 loss on the sale of the home ($150,000 basis − $90,000 sale proceeds). This was his personal residence, so the loss is not deductible.

34. IRC §163(h)(3)(B)(i).

35. IRC §108(h)(2).

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Example 10. Michael Easton wanted to marry his long-time girlfriend, Fiona. He purchased a home in Miami for $400,000. He took out a mortgage for $320,000 and made an $80,000 down payment. The home is used as security for the recourse mortgage.

When Fiona moved in, she insisted on new shelving for the home to showcase her snow globes. Michael took out a second recourse mortgage for $20,000 to finance the improvement to the home.

Michael decided to refinance the two mortgages, which, at that time, had a combined loan balance of $330,000. The value of the home had increased to $450,000, so he was able to replace the two mortgages with a new recourse loan in the amount of $400,000. He used the additional $70,000 to pay for a vacation to Ireland. Unfortunately, while he was away, Michael lost his job and was left with no steady income. Shortly thereafter, the housing market suffered a major downturn and the lender foreclosed the home. The home sold at auction in 2013 for $325,000. The bank agreed to cancel the remaining debt for which Michael was personally liable, which was $75,000 ($400,000 loan amount − $325,000 sale proceeds).

Of the $75,000 of canceled debt income, only $5,000 qualifies as QPRI. The remainder is income for which no other exclusion applies because Michael is not insolvent.

Mortgage balance at time of refinancing	$400,000
FMV of home at time of foreclosure	325,000
Total canceled debt	$ 75,000
Nonqualified debt (amount used for vacation)	(70,000)
Debt excludable as QPRI	$ 5,000

The bank issued the following Form 1099-C.

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city or town, province or state, country, ZIP, or foreign postal code, and telephone no. **Miami General Bank** **1212 Florida Rd** **Miami, FL 12345**	1 Date of identifiable event **01/01/2013** 2 Amount of debt discharged $ **75000.00** 3 Interest if included in box 2 $	OMB No. 1545-1424 **2013** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S federal identification number **12-3456789** / DEBTOR'S identification number **123-45-6789**	4 Debt description **Home mortgage loan**		**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 **Michael Easton** Street address (including apt. no.) **123 Warehouse Rd, No. 123** City or town, province or state, country, and ZIP or foreign postal code **Miami, FL 12345**	5 If checked, the debtor was personally liable for repayment of the debt . . . . ▶ ☒		
Account number (see instructions) **999999999-0**	6 Identifiable event code **D**	7 Fair market value of property $ **325000.00**	

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

Michael reports the $70,000 of nonexcludable cancellation of debt income on line 21 of his Form 1040.

payment. Also, please use **Form 1040-V.**	20a	Social security benefits 20a	b Taxable amount . . .	20b	
	21	Other income. List type and amount cancellation of debt	21	70,000
	22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	
	23	Educator expenses 23		

Michael's Form 982 reflects the $5,000 QPRI exclusion as follows.

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For Example 10

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
Michael Easton	123-45-6789

Part I **General Information** (see instructions)

DRAFT AS OF May 16, 2013

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	5,000
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 ☐ 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 appli...

TAX ATTRIBUTES

If a debtor excludes canceled debt from income because it is canceled in a bankruptcy case, during insolvency, or is related to qualified farm indebtedness, the debtor must use the excluded amount to reduce certain tax attributes.[36] Tax attributes include losses and credits and the basis of certain assets. The effect of reducing tax attributes is that the tax on the canceled debt is partially postponed instead of being entirely forgiven. This prevents any tax benefit to the taxpayer from the debt cancellation.

If the debt was forgiven under an individual Chapter 7 or Chapter 11 bankruptcy, then the trustee reduces the estate's attributes by the canceled debt (but not below zero). The bankruptcy estate may use tax attributes in the same way the debtor would have.

Order of Reduction

Generally, the amount of canceled debt should be used to reduce the tax attributes in the following order.[37]

- **Net operating loss.** Reduce any NOL for the tax year in which the debt cancellation takes place and any NOL carryover to that tax year.
- **General business credit carryovers.** Reduce any carryovers, to or from the tax year of the debt cancellation, of amounts used to determine the general business credit.
- **Minimum tax credit.** Reduce any minimum tax credit available as of the beginning of the tax year following the tax year of the debt cancellation.
- **Capital losses.** Reduce any net capital loss for the tax year of the debt cancellation and any capital loss carryover to that year.
- **Basis.** Reduce basis in depreciable and nondepreciable property.

Note. The estate, in the case of an individual bankruptcy under Chapter 7 or 11, may choose to reduce the basis of depreciable property **before** reducing any other tax attributes.

36. IRC §108(b)(1).

37. IRS Pub. 908, *Bankruptcy Tax Guide*.

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- **Passive activity loss and credit carryovers.** Reduce any passive activity loss or credit carryover from the tax year of the debt cancellation.
- **Foreign tax credit.** Reduce any carryover, to or from the tax year of the debt cancellation, of an amount used to determine the foreign tax credit.

Note. Because the attributed carryovers are determined on the first day of the bankruptcy filing, the debtor should consider making an election to have two short tax years in the year of filing if the debtor has significant carryovers. The first short tax year would end the day before the bankruptcy petition is filed. This would prevent the debtor's personal loss of all the carryovers. These carryovers transfer to the estate on the date the bankruptcy petition is filed and would no longer be available to the individual.

Upon termination of the bankruptcy case or when the estate is terminated, the debtor assumes any remaining tax attributes taken by the bankruptcy estate. The debtor also assumes any attributes that arose during the estate's administration. The debtor does not, however, assume any of the estate's administrative expense losses because the debtor cannot deduct administrative expenses.

The debtor cannot carry back any NOL or credit from a tax year ending after the bankruptcy case began to any tax year ending before the case began. If the estate has an NOL or excess credit that does not transfer to the debtor, the estate can carry back the NOL or credit to the estate's previous tax years as well as to prebankruptcy tax years.

Amount of Reduction

Except for credit carryovers, tax attributes should be reduced in the same amount as the canceled debt that is excluded from income. Credit carryovers should be reduced by 33⅓ cents for each dollar of canceled debt excluded from income.

Making the Reduction

The required reductions in tax attributes are made after calculating the tax for the year of the debt cancellation. NOLs and capital losses should be reduced first in the year of the debt cancellation; any carryovers should be reduced in order of the tax years from which the carryovers arose, starting with the earliest year. Reductions of credit carryovers should be made in the order in which the carryovers are taken into account for the tax year of the debt cancellation.

Tax attributes in individual Chapter 7 or Chapter 11 bankruptcies should be made in the bankruptcy estate by the trustee. The trustee can decide whether to reduce the basis of depreciable property first before reducing other tax attributes.

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Basis Reduction

If any amount of debt cancellation reduces the basis of an asset, the following rules apply.

- The reduction should be made at the beginning of the tax year following the year of debt cancellation and should be applied to all property held at the time of the reduction.[38]
- The reduction in basis cannot be more than the total basis of the property held immediately after the cancellation, minus total liabilities immediately after the debt cancellation. This limit does not apply if an election is made to reduce basis before reducing other attributes.
- No reduction in basis should be made on property that the debtor treats as exempt property under 11 USC §522.
- An election can be made to reduce the basis of depreciable property before reducing other tax attributes. This reduction cannot be more than the total basis of depreciable property held at the beginning of the tax year after the debt cancellation. The election should be made on Form 982 for the tax year of the debt cancellation. However, if the debtor establishes reasonable cause, the election can be made on an amended return. Once the election is made, it cannot be revoked without IRS approval.
- If any basis in property is reduced and is later sold for a gain, the portion of the gain corresponding to the basis reduction is taxable as ordinary income. The ordinary income can be computed by treating the amount of the basis reduction as a depreciation deduction and by treating the basis-reduced property as IRC §1245 property (if it is not already §1245 or §1250 property). If the property is §1250 property, the determination of what the straight-line depreciation would have been is made as though there had been no basis reduction associated with the debt cancellation.[39]

Example 11. Shelleen Flanagan purchased a home in Boston in 2010 for $200,000. She made a 5% down payment and financed the remaining $190,000 with Running Bear Bank. She is personally liable for the debt.

By 2012, the value of her home had decreased tremendously and was only worth $150,000, but she still owed $185,000 on the loan. In 2013, Shelleen convinced the bank to modify her loan and allow her to remain in the home. The bank reduced the principal owed to reflect the current value of the home ($150,000) and forgave the remaining $35,000 ($185,000 mortgage balance − $150,000 FMV).

Shelleen should check the box on Form 982, line 1e. On line 2, she reports the $35,000 of canceled debt. She also enters this amount on line Form 982, 10b, and reduces the basis in her home accordingly. She does not include the $35,000 as income on her Form 1040.

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38. Treas. Reg. §1.1017-1.

39. See IRS Pub. 544, *Sales and Other Dispositions of Assets,* for information on §§1245 and 1250.

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For Example 11

DRAFT AS OF May 16, 2013 DO NOT FILE

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
Shelleen Flanagan	111-11-1111

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	35,000
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 ☐ 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	35,000

For a discharge of qualified farm indebtedness applied to reduce the basis of:

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LOAN MODIFICATIONS FOR HOMEOWNERS IN HARDSHIP

There are several government programs to assist homeowners in refinancing their mortgage if they owe more than their home is currently worth, are delinquent in their payments, or are at risk of delinquency due to a financial hardship.

Any loan modification made under the programs described in this section can result in tax implications for the taxpayer. If more than $600 of debt is forgiven, the taxpayer will receive a Form 1099-C from the lender, and the amount of debt forgiven must generally be included in the taxpayer's ordinary income. The taxpayer should be aware of the possibility of a potential tax liability resulting from these programs unless the forgiven debt qualifies for one of the exclusions described earlier, such as QPRI or insolvency.

HOME AFFORDABLE MODIFICATION PROGRAM (HAMP)® [40]

For homeowners struggling to make their mortgage payments, HAMP may help the homeowner lower their monthly obligations. The program applies to homeowners occupying their primary residence. HAMP requires borrowers to enter into a trial period plan before receiving a permanent modification. During this period, borrowers must submit trial payments and all required forms and documents. HAMP generally uses leftover bank bailout funds to pay banks and mortgage companies who agree to reduce loan balances.

The program was expanded June 1, 2012. As a result, the following homeowners may now be eligible for HAMP.

- Homeowners applying for a modification on a home that is not their primary residence but which is currently rented or which the homeowner intends to rent
- Homeowners who previously did not qualify for HAMP because their debt-to-income ratio was 31% or lower
- Homeowners who received a HAMP trial period plan but defaulted in their trial payments
- Homeowners who previously received a HAMP permanent modification but defaulted in their payments, thereby losing good standing

The program has the following eligibility requirements.

- The mortgage must have been obtained on or before January 1, 2009, and must have been bought by Fannie Mae or Freddie Mac before June 1, 2009.
- The mortgage must not exceed $729,750 on a primary residence or single-unit rental property, $934,200 on a 2-unit rental property, $1,129,250 on a 3-unit rental property, or $1,403,400 on a 4-unit rental property.
- The property must not have been condemned.
- The homeowner must be experiencing financial hardship and be either currently delinquent or in danger of falling behind on mortgage payments.
- The homeowner must have documented income that supports a modified payment.
- The homeowner must not have been convicted of felony larceny, theft, fraud, forgery, money laundering, or tax evasion in connection with a mortgage or real estate transaction within the last 10 years.

The Secretary of the Treasury has established a website that allows homeowners to enter their monthly mortgage payment amount and gross monthly income and obtain information regarding whether they would likely be accepted or rejected for modification under HAMP. This calculator is available at **www.makinghomeaffordable.gov/get-assistance/payment-reduction/Pages/default.aspx.**

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40. *Home Affordable Modification Program.* [www.makinghomeaffordable.gov/programs/lower-payments/Pages/hamp.aspx] Accessed on Jul. 9, 2013.

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To apply for HAMP, the taxpayer must provide the following information.

1. Request for Mortgage Assistance Form
2. IRS Form 4506T-EZ, *Short Form Request for Individual Tax Return Transcript,* or Form 4506-T, *Request for Transcript of Tax Return*
3. Verification of income

The forms are available online at **www.makinghomeaffordable.gov/programs/lower-payments/Pages/hamp.aspx.** The completed paperwork should be provided to a participating mortgage servicer.[41] If the homeowner does not qualify for HAMP, an alternative program may be available.

Example 12. Bonnie and Clyde's business had been going gangbusters, but then the economy collapsed. As a result, the couple was barely able to keep up on their mortgage payments, but they were able to maintain their debt-to-income ratio at 31%.

On May 23, 2013, they decided to apply for a mortgage modification under HAMP. As part of their application, they completed the following hardship affidavit.

Making Home Affordable Program
Hardship Affidavit

MAKING HOME AFFORDABLE.gov

HARDSHIP AFFIDAVIT page 1 | COMPLETE ALL THREE PAGES OF THIS FORM

Loan I.D. Number 12-12-12-12 | Servicer Texas Rangers

BORROWER	CO-BORROWER
Borrower's name Clyde Barrow	Co-borrower's name Bonnie Parker
Social Security Number 123-45-6789	Social Security Number 222-22-2222

Property address (include city, state and zip): 999 Rural Rd. Bienville Parish, LA 66778

I want to:	☒ Keep the Property	☐ Sell the Property		
The property is my:	☒ Principal Residence	☐ Second Home / Seasonal Rental	☐ Year-Round Rental	
The property is:	☒ Owner Occupied	☐ Tenant Occupied	☐ Vacant	☐ Other ____________

HARDSHIP AFFIDAVIT

I (We) am/are requesting review under the Making Home Affordable (MHA) Program.
I am having difficulty making my monthly payment because of financial difficulties created by (check all that apply):

☒ My household income has been reduced. For example: reduced pay or hours, decline in business earnings, death, disability or divorce of a borrower or co-borrower.	☐ My monthly debt payments are excessive and I am overextended with my creditors. Debt includes credit cards, home equity or other debt.
☐ My expenses have increased. For example: monthly mortgage payment reset, high medical or health care costs, uninsured losses, increased utilities or property taxes.	☒ My cash reserves, including all liquid assets, are insufficient to maintain my current mortgage payment and cover basic living expenses at the same time.
☐ I am unemployed and (a) I am receiving/will receive unemployment benefits or (b) my unemployment benefits ended less than 6 months ago.	☐ Other:

Explanation (continue on back of page 3 if necessary): ________________________________

Have you filed for bankruptcy? ☐Yes ☒ No If yes: ☐ Chapter 7 ☐ Chapter 13 *Filing Date:*____________________
Has your bankruptcy been discharged? ☐Yes ☐No *Bankruptcy case number* ____________________

How many single-family properties, other than your personal residence, do you and/or your co-borrower(s) own individually, jointly, or with others? 1

Has the mortgage on your principle residence ever had a Home Affordable Modification Program (HAMP) permanent modification?

[41] Not all mortgage providers participate in HAMP, but all mortgage companies with loans owned by Fannie Mae and Freddie Mac are required to participate. A list of participating providers is available at www.makinghomeaffordable.gov/get-started/contact-mortgage/Pages/default.aspx.

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HOME AFFORDABLE REFINANCE PROGRAM (HARP)[42]

For homeowners who have been unable to get traditional refinancing because the value of the home has declined, HARP may be able to provide a new, more affordable, and more stable mortgage. HARP refinance loans require a loan application and underwriting process, and refinance fees apply. The program is scheduled to end December 31, 2015.

Homeowners may be eligible for HARP if they meet all of the following criteria.

1. The mortgage must be owned or guaranteed by Freddie Mac or Fannie Mae.
2. The mortgage must have been sold to Freddie Mac or Fannie Mae on or before May 31, 2009.
3. The mortgage cannot have been previously refinanced under HARP unless it is a Fannie Mae loan that was refinanced under HARP between March and May of 2009.
4. The current loan-to-value ratio must be greater than 80%.
5. The borrower must be current on the mortgage at the time of the refinance, with a good payment history in the past 12 months.

Homeowners whose loans are owned by Freddie Mac can check their potential eligibility for HARP at **www.freddiemac.com/avoidforeclosure/harp_eligibility.html.** Homeowners whose loans are owned by Fannie Mae can check their potential eligibility at **https://knowyouroptions.com/loanlookup.**

FHA SHORT REFINANCE[43]

Homeowners who are not behind on their payments but who owe more than their home is worth may be eligible for FHA Short Refinance. This program is designed to help homeowners refinance into an affordable, stable FHA-insured mortgage. Lenders that agree to participate in this type of refinance are required to reduce the amount the homeowner owes on the first mortgage to no more than 97.75% of the home's current value. The participation of mortgage servicers in this program is voluntary, so the homeowner will need to ask their lender whether they participate in FHA Short Refinance.

The following are the eligibility requirements for the FHA Short Refinance program.

1. The mortgage must not be owned or guaranteed by the FHA, VA, or USDA.
2. The homeowner must owe more than the home is worth.
3. The homeowner must be current on mortgage payments.
4. The homeowner must occupy the house as their primary residence.
5. The homeowner must qualify for a new loan under standard FHA underwriting requirements.
6. The homeowner's total debt must not exceed 50% of their monthly gross income.
7. The homeowner must not have been convicted of felony larceny, theft, fraud, forgery, money laundering, or tax evasion in connection with a mortgage or real estate transaction within the last 10 years.

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42. *Home Affordable Refinance Program (HARP).* [www.makinghomeaffordable.gov/programs/lower-rates/Pages/harp.aspx] Accessed on Jul. 9, 2013.

43. *FHA Refinance for Borrowers with Negative Equity (FHA Short Refinance).* [www.makinghomeaffordable.gov/programs/lower-rates/Pages/short-refinance.aspx] Accessed on Jul. 9, 2013.

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PRINCIPAL REDUCTION ALTERNATIVE (PRA)[44]

The Principal Reduction Alternative (PRA) program is available for homeowners whose homes are worth significantly less than the amount owed. The PRA program may be combined with HAMP if the ratio of the amount owed to the value of the home is greater than 115%.[45]

The program has the following eligibility requirements.

1. The mortgage must not be owned or guaranteed by Fannie Mae or Freddie Mac.
2. The homeowner must owe more than the house is worth.
3. The homeowner must occupy the house as their primary residence.
4. The mortgage must have been obtained on or before January 1, 2009.
5. The mortgage payment must be more than 31% of the homeowner's gross monthly income.
6. The homeowner must not owe more than $729,750 on the first mortgage.
7. The homeowner must be experiencing financial hardship and be either delinquent or in danger of falling behind on payments.
8. The homeowner must have sufficient, documented income to support the modified payment.
9. The homeowner must not have been convicted within the last 10 years of felony larceny, theft, fraud, forgery, money laundering, or tax evasion in connection with a mortgage or real estate transaction.

HAMP-PRA MODIFICATIONS[46]

If a mortgage loan is being considered for a HAMP modification and the ratio of the amount owed to the value of the home is greater than 115%, then the loan servicer must consider whether a principal reduction under the PRA program should be effected as one part of the HAMP modification. Under a HAMP-PRA modification, the principal of the homeowner's loan may be reduced by a predetermined amount called the "PRA forbearance amount."

For HAMP-PRA modifications, the unpaid principal balance of the modified loan is divided into an interest-bearing principal amount and a non-interest-bearing PRA forbearance amount. If the loan is in good standing on the first, second, and third anniversaries of the effective date of the trial period, the loan servicer reduces the unpaid principal balance of the loan by one-third of the initial PRA forbearance amount on each anniversary date. Therefore, if the homeowner makes timely payments on the loan for three years, the entire PRA forbearance amount is forgiven. To encourage mortgage loan holders to participate in HAMP-PRA modifications, HAMP makes PRA investor incentive payments to the loan holders for each of the three years in which the loan principal balance is reduced.

The PRA investor incentive payment to the holder is treated as a payment on the loan by the government on behalf of the homeowner. The homeowner does **not** have income as a result of the government paying some of the loan. The payment by the government on behalf of the homeowner is excludable from the homeowner's income under the general welfare exclusion.[47]

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44. *Principal Reduction Alternative (PRA).* [www.makinghomeaffordable.gov/programs/lower-payments/Pages/pra.aspx] Accessed on Jul. 9, 2013.

45. *Principal Reduction Alternative under the Home Affordable Modification Program.* [www.irs.gov/uac/Principal-Reduction-Alternative-Under-the-Home-Affordable-Modification-Program] Accessed on Jul. 9, 2013.

46. Rev. Proc. 2013-16, 2013-7 IRB 488; *Principal Reduction Alternative under the Home Affordable Modification Program.* [www.irs.gov/uac/Principal-Reduction-Alternative-Under-the-Home-Affordable-Modification-Program] Accessed on Jul. 9, 2013.

47. See Rev. Rul. 2009-19, 2009-2 CB 111.

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PRA Forbearance Amount as Discharged Indebtedness

In a HAMP-PRA modification, the holder of the loan reduces the PRA forbearance amount by more than the PRA investor incentive payments. To the extent that the reduction in the PRA forbearance amount is more than the PRA investor incentive payments, the reduction is from the discharge of indebtedness. The full amount of the discharge of indebtedness is reported to the IRS and the homeowner on Form 1099-C.[48]

The discharged indebtedness may be reported either in the year of the permanent modification of the mortgage loan or ratably over the three years in which the mortgage loan principal is reduced. The amount of the income and any resulting reduction in basis or tax attributes should be reported on Form 982.

If the amount discharged meets the criteria for QPRI, the exclusion may apply to a discharge of indebtedness under PRA. If the QPRI does not apply to the discharged debt, then the insolvency exclusion may apply to a discharge of indebtedness under a PRA principal reduction to the extent that the taxpayer is insolvent when the discharge occurs. (More information on QPRI and insolvency is provided earlier in this chapter.)

> **Note.** Due to the uncertainty about the continued availability of the QPRI exclusion, participants may want to consider reporting the discharged indebtedness under HAMP all at one time. Even if the taxpayer was set to receive the reductions over three years, the taxpayer can change the reduction schedule, claiming the entire reduced principal in their 2013 income using Form 982.[49]

FHA SECOND LIEN PROGRAM (FHA2LP)[50]

If the homeowner has a second mortgage and the first mortgage servicer agrees to participate in FHA Short Refinance, the homeowner may be eligible to have the second mortgage on the same home reduced or eliminated through the FHA Second Lien Program (FHA2LP). If the service provider agrees to participate, the total amount of the mortgage debt after the refinance cannot exceed 115% of the home's current value.

Homeowners may be eligible for FHA2LP if they meet the following criteria.

1. They are eligible for FHA Short Refinance.
2. They obtained their mortgage on or before January 1, 2009.
3. They were not convicted of felony larceny, theft, fraud, forgery, money laundering, or tax evasion in connection with a mortgage or real estate transaction within the last 10 years.

> **Note.** The IRS has not issued guidance on the FHA2LP program as it has with the PRA program, but the issues are similar. Under the FHA2LP program, the lender may be eligible for payments from the Treasury for the full or partial extinguishment of the second loan in order to facilitate the refinance of the first loan.[51]

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48. Rev. Proc. 2013-16, 2013-1 CB 488.

49. See Rev. Proc. 2013-16, 2013-1 CB 488.

50. *Treasury/FHA Second Lien Program (FHA2LP).* [www.makinghomeaffordable.gov/programs/lower-rates/Pages/fha2lp.aspx] Accessed on Jul. 9, 2013.

51. *Making Home Affordable Program: Handbook for Servicers of Non-GSE Mortgages.* [www.hmpadmin.com//portal/programs/docs/hamp_servicer/mhahandbook_33.pdf] Accessed on Jul. 19, 2013.

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TAX IMPLICATIONS

Early Payment of Mortgage Loan

If the taxpayer pays off their home mortgage early, there may be a penalty assessed. The taxpayer can deduct that penalty as home mortgage interest on their tax return, provided the penalty is not for a specific service performed or cost incurred in connection with their mortgage loan.

If a lender offers a discount to the principal balance of a loan for early repayment or agrees to a loan modification that reduces the principal balance, the discount or reduction is canceled debt. The canceled debt is taxable as ordinary income unless an exception applies. If this reduction or modification is for the mortgage of the taxpayer's principal residence, for instance, the QPRI exclusion may apply. If the debt is nonrecourse, however, and the taxpayer does not retain the collateral, then there is no cancellation of debt.

Short Sales

"Short sale" is a common term referring to a situation in which a homeowner sells a house for less than the existing mortgage balance. The seller then requests that the lender forgive the remaining, unpaid mortgage balance. If the lender agrees, the lender receives the entire sale price for the home in return for forgiving the outstanding difference between the mortgage and the sale price.

A short sale is taxed in the same manner as a foreclosure. If the debt is recourse debt, the canceled debt is not satisfied with the surrender of the property. Therefore, any debt not satisfied with the sales proceeds is taxable cancellation of debt income. The amount **realized** from the sale of the property that secures a recourse liability does not include amounts that are income from the discharge of indebtedness. The transaction is bifurcated into a taxable sale of property and a taxable discharge of indebtedness. The lender sends the seller a Form 1099-C, which reports the amount of the mortgage debt that was canceled.

> **Note.** A short sale may be preferable to a lender because it frequently involves less cost than a foreclosure. In a short sale, the debtor sells the property and the lender receives a certain amount. In a foreclosure, the lender must sell the property, which could cost more to the lender in time and effort and could result in a lower sales price.

If the short sale involves nonrecourse debt and the seller and buyer require cancellation of the remaining debt as a condition of the sale, the amount of the debt canceled is included in the sale proceeds. If the sale involves a principal residence, the taxpayer may qualify for the exclusion from income of the gain from the sale. This makes a short sale on a nonrecourse debt a viable alternative to foreclosure.

Example 13. Lily Munster purchased her primary residence in 2007 for $500,000 subject to an interest-only **recourse mortgage** of $480,000. Her economic situation weakened dramatically in 2010 when her husband began working the graveyard shift and she was left with primary responsibility to care for her grandfather and keep him out of trouble.

Lily arranged with the lender for a short sale. By that time, the value of homes in her neighborhood had declined, and hers was no exception. It was worth only $350,000, and the home sold for this amount. The lender received the sale proceeds net of the cost of the sale, which was $325,500 ($350,000 selling price – $24,500 cost of sale). As part of the agreement, the lender forgave the remaining debt owed by Lily, which was $154,500 ($480,000 – $325,500).

Lily had a loss of $174,500 ($500,000 basis – $325,500 net sales price). This loss is not deductible for Lily because it is from a personal asset. Lily would have income in the amount of the canceled debt, but she could use the QPRI exception to exclude this amount.

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Example 14. Lily Munster's niece, Marilyn, purchased her primary residence in 2005 for $300,000, subject to a **nonrecourse mortgage** of $250,000. Marilyn's economic situation worsened dramatically in 2012 when she was unable to win a single beauty pageant.

Marilyn arranged with the lender for a short sale. By that time, she owed $225,000 on the mortgage, but her home was only worth $190,000 and it sold for that amount. The lender received the sale proceeds net of the cost of sale, which was $178,600 ($190,000 proceeds – $11,400 cost of sale). The lender forgave the remaining debt owed by Marilyn, which was $46,400 ($225,000 – $178,600). Marilyn's debt was nonrecourse, so the amount Marilyn realized is the net sale proceeds plus the amount of forgiven debt, which is $225,000 ($178,600 + $46,400). Therefore, Marilyn has a nondeductible loss of $75,000 ($300,000 basis – $225,000), but she has no income from the canceled nonrecourse debt.

FORECLOSURES AND REPOSSESSIONS

When the taxpayer fails to make payments on a loan that is secured by property, the lender may foreclose the loan or repossess the property. For tax purposes, this is treated as a sale or exchange, which may give rise to a gain or a loss.

If the loan balance was more than the FMV of the property and the remaining balance of the loan is canceled, there may be ordinary income from the cancellation of the remaining debt. This amount may be excluded from income if the taxpayer qualifies for one of the exceptions discussed earlier in this chapter, such as insolvency.

Thus, transactions involving foreclosures and repossessions have two tax issues to consider.

1. The gain or loss on the disposition of the property
2. The amount, if any, of cancellation of debt income

CALCULATING GAIN OR LOSS

Gain or loss from a foreclosure or repossession is calculated in the same way as gain or loss from a sale and should be reported similarly. The gain is calculated as the excess of the amount realized over the adjusted basis in the property. The loss is the excess of the adjusted basis in the transferred property over the amount realized. Losses from the sale or foreclosure of personal property are not deductible.

For **recourse debt,** the amount realized on the foreclosure or repossession is the smaller of the following.

- The outstanding debt immediately before the transfer, reduced by any amount for which the taxpayer remains personally liable immediately after the transfer
- The FMV of the transferred property

Note. For more information, see IRS Pub. 544, *Sales and Other Dispositions of Assets.*

In addition, if there is a recourse loan on the repossessed property and the balance is more than the FMV of the property, ordinary income may be realized if the lender cancels the remaining loan.

For **nonrecourse debt,** the taxpayer realizes an amount that includes the full outstanding debt immediately before the transfer. Even if the FMV of the property is less than the outstanding debt, the full amount of the outstanding debt is still realized.

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Example 15. Geoff Jordan is an amateur car racing enthusiast. He bought a new race car for $30,000. He paid $10,000 down and borrowed the remaining $20,000 through seller financing. Geoff is personally liable for the loan and pledged the car as security for the loan. The seller ultimately repossessed the car because Geoff had stopped making loan payments after a series of bad races. The balance due at the time of repossession was $10,000. The FMV of the car when it was repossessed was $3,000 because of the sustained high speed use of the car. The seller forgave the remaining balance on the loan.

Because Geoff's debt is recourse, the amount realized on the repossession is calculated as the smaller of the following amounts.

- The $10,000 outstanding debt immediately before the repossession, reduced by the $7,000 for which he remains personally liable immediately after the repossession, or $3,000
- The $3,000 FMV of the car

Geoff calculates his gain or loss on the repossession by comparing the amount realized of $3,000 with his $30,000 adjusted basis. He has a $27,000 nondeductible loss because the car was not used in a trade or business. After the cancellation of the remaining balance on the loan, Geoff also has ordinary income from cancellation of debt in the amount of $7,000 ($10,000 balance due at time of repossession − $3,000 FMV of car). Geoff must report this $7,000 on his tax return as income unless he qualifies for the insolvency exception.

INSTALLMENT SALES

An installment sale is a sale of property in which at least one payment is received after the tax year in which the sale occurs.[52] The seller is required to report a gain on an installment sale under the installment method unless they make an election to not use the installment method on or before the due date (including extensions) for filing their tax return for the year of the sale. The election can be made by reporting all the gain as income in the year of the sale on Form 4797, *Sales of Business Property*; Form 8949, *Sales and Other Dispositions of Capital Assets;* or both.

> **Note.** Installment method rules do not apply to sales that result in a loss.

Form 6252, *Installment Sale Income*, is used to report a sale of property on the installment method. Form 6252 is used both to report the sale in the year it takes place and to report payments received in later years.

If property is **repossessed** after an installment sale is initiated, then the taxpayer repossessing the property must determine the gain or loss on the repossession and the adjusted basis of the repossessed property.

The rules for calculating these amounts depend on the kind of property repossessed. The rules that apply to personal property are different from those that apply to real property.

> **Note.** The title does not have to have been transferred for the repossession rules to apply. The taxpayer must either foreclose on the property or have the buyer voluntarily relinquish the property to the taxpayer for the repossession rules to apply. In addition, the property must secure the installment obligation and repossession of the property must at least partially satisfy the buyer's obligation.

52. IRC §453(b)(1).

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Personal Property[53]

If the original sale was reported using the installment method, the basis in personal property is calculated by multiplying the unpaid balance of the installment obligation by the gross profit percentage. This amount is subtracted from the unpaid balance. The result is the basis in the installment obligation.

Note. For information on how to calculate the gross profit percentage, see IRS Pub. 537, *Installment Sales.*

If the FMV of the repossessed property is more than the total of the taxpayer's basis in the obligation plus any repossession costs, the taxpayer has a gain. If the FMV is less, the taxpayer has a loss. This gain or loss on the repossession has the same character (capital or ordinary) as the original sale.

Example 16. Use the same facts as **Example 15.** The seller's gross profit percentage is 30% and it cost the seller $1,000 to repossess the car. The seller reported the original sale on its tax return using the installment method.

The seller's loss can be calculated using a worksheet from IRS Pub. 537, as follows.

Worksheet C. **Figuring Gain or Loss on Repossession of Personal Property**

Note. *Use this worksheet only if you used the installment method to report the gain on the original sale.*

Keep for Your Records

1.	Enter the fair market value of the repossessed property		3,000
2.	Enter the unpaid balance of the installment obligation	10,000	
3.	Enter your gross profit percentage for the installment sale	30%	
4.	Multiply line 2 by line 3. This is your unrealized profit	3,000	
5.	Subtract line 4 from line 2. This is the basis of the obligation		7,000
6.	Enter your costs of repossessing the property		1,000
7.	Add lines 5 and 6		8,000
8.	Subtract line 7 from line 1. This is your gain or loss on the repossession		(5,000)

Real Property[54]

The rules for the repossession of real property allow the taxpayer to keep essentially the same adjusted basis in the repossessed property that they had before the original installment sale. The taxpayer can recover the entire basis when the property is resold. This effectively cancels out the tax treatment that applied to the taxpayer on the original installment sale and puts the taxpayer in the same tax position that they were in before the sale.

As a result, the total payments the taxpayer received from the buyer on the original sale must be considered income. Any part of the payments that have not yet been included in income is considered gain on the repossession. These payments are amounts that the taxpayer previously treated as a return of basis and therefore did not include in income. However, the total gain that must be reported is limited (as explained later in this section).

53. IRS Pub. 537, *Installment Sales.*

54. Ibid.

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Rules concerning basis and gain on repossessed real property are mandatory. The taxpayer must use these rules to calculate the basis in the repossessed real property and gain on the repossession. The rules apply regardless of whether or not the taxpayer reported the sale on the installment method. However, the rules apply **only** if all of the following conditions are met.

1. The repossession was to protect the taxpayer's security rights in the property.
2. The installment obligation satisfied by the repossession must have been received in the original sale.
3. The taxpayer did not pay any additional consideration to the buyer to get the property back unless either of the following situations applies.
   - **a.** The requisition and payment of the additional consideration were provided for in the original contract of sale.
   - **b.** The buyer has defaulted, or default is imminent.

If any one of the preceding three conditions is not met, the rules for repossessed personal property should be used, as if the property repossessed were personal rather than real property.

Calculating Gain on Repossession. The gain on the repossession of real property is either ordinary income or capital gain, the same as the gain on the original sale. However, if the taxpayer did not report the sale on the installment method, the gain on repossession is ordinary income.

The taxpayer's gain on repossession is the difference between the following amounts.

- The total payments received, or considered received, on the sale
- The total gain already reported as income

Taxable gain, however, is **limited** to the taxpayer's gross profit on the original sale minus the sum of the following.

- The gain on the sale the taxpayer reported as income before the repossession
- Repossession costs (Repossession costs include money or property paid to reacquire the property, such as court costs and legal fees, publishing costs, recording fees, and lien clearance.)

This method of calculating taxable gain essentially treats all payments received as income, but limits the taxable gain to the gross profit the taxpayer originally expected on the sale. The limit on taxable income does not apply if the selling price is indefinite and cannot be determined at the time of the repossession. An example of an indefinite selling price is when the selling price is stated as a percentage of profits from the development of the real property.

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Example 17. Ben Cartwright sold a tract of land in January 2010 for $25,000 to Matt Dillon. He accepted a $5,000 down payment, plus a $20,000 mortgage secured by the property and payable at the rate of $4,000 annually plus interest (9.5%). The payments began on January 1, 2011. The adjusted basis in the property was $19,000 and Ben reported the transaction as an installment sale. His selling expenses were $1,000. Ben calculated his gross profit as follows.[55]

Selling price		$25,000
Adjusted basis	$19,000	
Selling expenses	1,000	
	$20,000	(20,000)
Gross profit		$ 5,000

For this sale, the contract price equals the selling price. The gross profit percentage is 20% ($5,000 gross profit ÷ $25,000 contract price).

In 2010, Ben included $1,000 in income (20% × $5,000 down payment) on Form 6252. In 2011, Ben reported a profit of $800 (20% × $4,000 annual installment). In 2012, Matt Dillon defaulted and Ben repossessed the property. He paid $500 in legal fees to get the property back. The taxable gain on the repossession is calculated as follows, using a worksheet from IRS Pub. 537.

Worksheet D. **Taxable Gain on Repossession of Real Property**

Note. *Use this worksheet to determine taxable gain on the repossession of real property if you used the installment method to report the gain on the original sale.*

Keep for Your Records

1.	Enter the total of all payments received or treated as received before repossession	**9,000**	(Principal only)
2.	Enter the total gain already reported as income	**1,800**	($1,000 + $800)
3.	Subtract line 2 from line 1. This is your gain on the repossession	**7,200**	(Previously untaxed principal payments)
4.	Enter your gross profit on the original sale	**5,000**	
5.	Enter your costs of repossessing the property	**500**	
6.	Add line 2 and line 5	**2,300**	(Previously taxed principal + costs of reposssession)
7.	Subtract line 6 from line 4	**2,700**	(Original gross profit — line 6)
8.	Enter the lesser of line 3 or line 7. This is your taxable gain on the repossession	**2,700**	(Limit of reportable gain)

Basis. The new basis in the repossessed real property is determined as of the date of repossession. It is the sum of the following amounts.

- Adjusted basis in the installment obligation
- Repossession costs
- Taxable gain on the repossession

To calculate the adjusted basis in the installment obligation at the time of repossession, the unpaid balance is multiplied by the gross profit percentage. This amount is subtracted from the unpaid balance.

55. This example is adapted from IRS Pub. 537, *Installment Sales.*

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Example 18. Use the same facts as **Example 17.** The unpaid balance of the installment obligation is $16,000 at the time of repossession ($20,000 note − $4,000 payment). Ben's basis in the repossessed property is calculated as follows, using a worksheet from IRS Pub. 537.

Worksheet E. **Basis of Repossessed Real Property** *Keep for Your Records*

1.	Enter the unpaid balance on the installment obligation	16,000
2.	Enter your gross profit percentage for the installment sale	20%
3.	Multiply line 1 by line 2. This is your unrealized profit	3,200
4.	Subtract line 3 from line 1. This is your adjusted basis in the installment obligation on the date of the repossession	12,800
5.	Enter your taxable gain on the repossession	2,700
6.	Enter your costs of repossessing the property	500
7.	Add lines 4, 5, and 6. This is your basis in the repossessed real property	16,000

There is another way to view the calculation of Ben's new adjusted basis in the property. Ben's original basis in the sale from **Example 17** was $20,000. As shown on line 3 of Worksheet D, he realized a gain of $7,200 on the repossession before repossession costs. It cost him $500 to repossess the property. Therefore, his net realized gain is $6,700.

However, he only included $2,700 of this gain in income (line 8 of Worksheet D). Therefore, $4,000 of the realized gain is deferred ($6,700 realized gain – $2,700 taxable gain). Because the gain is deferred, Ben reduces his original basis of $20,000 by the deferred gain of $4,000 to obtain his new adjusted basis of $16,000 in the property.

ABANDONMENT[56]

An abandonment occurs when possession and use of the property are given up voluntarily and permanently, with no intention to recover the property or transfer ownership to another person. There must be an intention to abandon the property and affirmative steps must be taken toward abandonment. The determination of whether abandonment occurred is based on the facts and circumstances of the situation.

> **Note.** For more information on what constitutes abandonment see Office of Chief Counsel IRS Memorandum 20133101F (August 2, 2013). This memorandum can be found at **www.irs.gov/pub/irs-lafa/20133101f.pdf.**

Because abandonment requires an intention to permanently give up possession without any intention to transfer ownership of the property to another person, a voluntary conveyance of the property in lieu of foreclosure is not abandonment. Instead, it is treated as the exchange of property to satisfy a debt.[57]

In most cases, if the taxpayer abandons property that is security for **recourse** debt, there is no recognition of gain or loss until a foreclosure is completed later. If the taxpayer abandons property that secures **nonrecourse** debt, the abandonment is treated as a sale or exchange. The amount realized is the amount of the nonrecourse debt. If the amount realized is more than the adjusted basis in the property, the taxpayer has a gain. If the adjusted basis is more than the amount realized, the taxpayer has a loss.

56. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments.*

57. For more information see "Sales and Exchanges" in IRS Pub. 544, *Sales and Other Dispositions of Assets.*

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2013 Workbook

FORM 1099-A

When a lender acquires an interest in the taxpayer's property through foreclosure, repossession, or abandonment, the lender generally sends a Form 1099-A, *Acquisition or Abandonment of Secured Property,* to the taxpayer. This form provides the necessary information for the taxpayer to calculate the gain or loss.

The lender completes the Form 1099-A in the following manner.

- Box 1 states the date the lender acquired the property, which is either the date that the title is transferred to the lender or the date of possession by the lender. If the property is purchased at a sale, the date of sale should be used unless the borrower has a right of redemption. If the borrower has a right of redemption, then the date the redemption period expires should be used. For an abandonment, the date shown is the date on which the lender first knew that the property was abandoned.
- Box 2 should list the balance of the debt outstanding as of the date listed in box 1.
- Box 4 shows the FMV of the property.
- Box 5 indicates whether the debt was recourse or nonrecourse.
- Box 6 should include a general description of the property.

Example 19. After the tragic death of his wife, Pat Jaine got a position with the police force solving crimes. The value of Pat's home diminished after his wife's death. It was worth only $60,000 but had a recourse mortgage loan with a balance of $100,000. Pat's adjusted basis in the home is $90,000.

Pat packed up his collection of suits and drove away, vowing to never step foot in the home again. The bank became aware that Pat had abandoned the property on January 3, 2013. The bank completed the foreclosure in 2013 and reduced the debt by the FMV of the home at the time of the foreclosure. Pat's remaining balance due of $40,000 ($100,000 mortgage balance – $60,000 FMV) was not forgiven by the bank. Therefore, the bank issued Pat the following Form 1099-A and did not issue a Form 1099-C.

☐ CORRECTED (if checked)

LENDER'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no. **Sacramento General Bank** **1212 Florida Rd** **Sacramento, IL 68000**			OMB No. 1545-0877 **2013** Form **1099-A**	**Acquisition or Abandonment of Secured Property**
LENDER'S federal identification number **98-7654321**	BORROWER'S identification number **987-65-3210**	1 Date of lender's acquisition or knowledge of abandonment **01/03/2013**	2 Balance of principal outstanding $ **100000.00**	**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 **Pat Jaine**		3	4 Fair market value of property $ **60000.00**	
Street address (including apt. no.) **987 Red John Ln**		5 If checked, the borrower was personally liable for repayment of the debt . . . . ▶ ☒		
City or town, province or state, country, and ZIP or foreign postal code **Sacramento, IL 68000**		6 Description of property **987 Red John Ln** **Sacramento, IL 68000**		
Account number (see instructions) **111111111-0**				

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

Because the bank completed the foreclosure in 2013, Pat must first determine if he has a gain or a loss on the abandonment and foreclosure. The amount realized on the foreclosure is calculated as follows.

Outstanding debt immediately before the transfer	$100,000
Less the amount for which he remains personally liable after the transfer	(40,000)
1. Net realized	$ 60,000
2. FMV of transferred property	$ 60,000
Amount realized on foreclosure (lesser of lines 1 and 2)	**$ 60,000**

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Pat's gain or loss is calculated by subtracting his basis from the lesser of line 1 or 2 above (which is $60,000 under both methods in this situation).

Amount realized	$60,000
Less: adjusted basis	(90,000)
Loss on foreclosure	($30,000)

Pat's $30,000 loss is not deductible because the home was a personal asset.

If the bank cancels the remaining balance in the future, Pat should receive a Form 1099-C for the amount of debt cancelled. At that time, Pat will have cancellation of debt income. The entire amount of the cancelled debt will be treated as ordinary income unless one of the following applies.

1. The debt is discharged in bankruptcy.
2. Pat is insolvent at the time the loan is forgiven.
3. Congress extends the QPRI exclusion.

Ordinary Income from Canceled Debt

If the abandoned property is security for recourse debt and the debt is canceled, the taxpayer may realize ordinary income equal to the canceled debt. This income is separate from any loss realized from the abandonment of the property.

The lender generally sends a Form 1099-A showing the information needed to calculate the loss from the abandonment of the property. If the taxpayer's debt is canceled and the lender must file Form 1099-C, the lender may include the information about the abandonment on that form rather than on Form 1099-A. In this situation, Form 1099-A is not required. See **Example 10** earlier in the chapter for application of this recent procedural change.

> **Note.** See *Malonzo v. Comm'r* in the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases, for a case related to canceled debt.

ABANDONED BUSINESS PROPERTY

Generally, a taxpayer is entitled to a deduction for losses sustained from the abandonment of business property. Loss from the abandonment of business or investment property is generally deductible as an ordinary loss if it is not treated as a sale or exchange. This applies to leasehold improvements made by the lessor made that were abandoned. The abandonment loss is deducted in the tax year in which the loss is sustained.[58]

Example 20. In 2011, Jason purchased business property for $100,000. He borrowed the entire purchase price with nonrecourse debt but secured the loan with the property. In 2013, Jason was unable to continue making his loan payments, so he decided to abandon the property on September 1, 2013. Because Jason was not personally liable for the debt, the abandonment is treated as a sale or exchange of the property in the 2013 tax year. At the time of the abandonment, Jason owed $90,000 on the loan, but the FMV of the property was only $75,000. The amount Jason realized is $90,000 (the amount owed on the loan) and his basis in the property is $100,000; therefore, he has a $10,000 deductible loss in 2013.

The lender sells the property at a foreclosure sale in 2013 but Jason does not realize gain or loss from the foreclosure sale. He also has no cancellation of debt income because it was a nonrecourse debt.

58. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

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