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Creative Asset Protection
Strategies, Inc.

Income Tax Rules for Short-Sales, Foreclosures, Deed-in-Lieu, Bankruptcy, and Debt Restructuring.



**You may owe IRS taxes on
what the lender writes off!**

The IRS considers any debt forgiven or written off to be taxable income to you!



Yes, there are some exceptions. Yes, there are ways to reduce or avoid the taxes on cancellation of debt income.

With careful planning and serious attention to the process, you may be

able to avoid paying taxes on the money that the lender forgave or wrote off on your loans, but the rules are very complicated and the penalties for getting it wrong are severe.

The IRS giveth and the IRS taketh away!

There are new (and better) rules for those who lose their principal residence, but even with the new rules the homeowner may have taxable income when their home is foreclosed or their mortgage is reduced by the bank.

Only debt that is incurred to purchase or improve your home qualifies for the new exclusion. The amount that is excluded must be used to reduce your tax basis in your home or other property. This means that the amount excluded this year may become taxable in a later year. Any portion of the cancelled debt that was not used to buy or improve your home is taxable income.

This brochure is written to give you an overview of the rules and to advise you of important records to organize so that you will be able to accurately file your return and be able to support your positions when IRS calls.

There are very few sections of the tax law that are more complicated or that provide the IRS with more opportunity to be subjective, so you must have excellent documentation to survive an audit.

Obviously we cannot cover every situation or every exception in this small brochure. If you have questions about what is written or just need more information, please contact us, we will help.

NOTE: This brochure does not discuss how to protect your assets and income in the face of a deficiency judgment in favor of the lender. Neither does this brochure discuss effective ways to separate viable assets from assets that may be the subject of action by the lender. We are pleased to discuss those subjects with you. Please call for an appointment.



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You may owe IRS taxes on what the lender writes off even if you lost money on the investment!

Do you have: Debt Cancellation Income?

Recourse Debt (personally liable):

Debt Cancellation Income (DCI) is essentially the amount by which the debt cancelled exceeds the fair value of the property secured by the debt. It is taxed as ordinary income. If the asset was a business asset, the income is business income.

When a lender takes property and discharges the debt, the transaction is treated as a sale of the property. Sales proceeds are calculated as the lesser of fair value or the amount of debt cancelled.

If the debt discharged exceeds the fair value and the fair value exceeds your tax basis, you will have a gain on the sale and have DCI. Any amount of debt discharged that was not used to acquire or substantially improve the asset must be treated as DCI (eg. If you consolidated your debts and paid off credit cards with your HELOC, or bought a car, took a trip, etc., that part of the debt discharged is taxable income.)

For recourse debt, the transaction is accounted for when the debt is discharged, when your personal liability has ended, not when the lender takes the property so you reporting the transaction may be delayed for several years.

Non-Recourse Debt (no personal liability):

The cancellation of non-recourse debt does not generate DCI. The amount of debt cancelled is treated as the sales price of the underlying asset unless the debtor is solvent. The result can be a gain or loss depending upon the circumstances.

However, if some portion of the debt cancelled was for funds utilized for purposes other than the acquisition or substantial improvement of the underlying asset, that portion would be DCI.

The importance of the distinction between recourse and non-recourse debt and whether the transaction gives rise to DCI or realized gain or both is that only DCI is subject to the bankruptcy and insolvency exceptions discussed elsewhere in this brochure.

Other Important Notes:

1. For principal residences, the amount of DCI that is excluded from income must be used to reduce the tax basis of the home or other assets. It is not simply forgotten by the IRS; it will likely result in income when the effected assets are later sold. The new rules take precedent over the bankruptcy and insolvency rules.
2. Restructuring or modifying a loan may result in DCI.
3. A loss on the sale of your personal residence does not generate a tax deduction or a deductible loss.
4. DCI occurs only when the debtor is discharged from liability by the lender. Failure of a creditor to pursue a claim within the appropriate statute of limitations, where there is no evidence the debt was intended to be forgiven, is not considered a discharge.
5. Abandonment of collateral pledged as security for a loan does not result in DCI. If the debt is non-recourse, the transaction is treated as a sale of the asset for the amount of the loan. If the debt is recourse debt and the creditor is in possession of the collateral, the taxpayer does not realize DCI unless the creditor enforces collection of the debt. There must be an affirmative showing that the taxpayer is in fact discharged from the debt to create DCI.
6. Tax accounting for DCI must be done when the debt is discharged, not when the lender takes the property. This could allow the debtor time to restructure their personal and business assets to take advantage of the insolvency exclusion with careful planning, or could result in a substantial liability if net worth grows from the time the property is taken until the discharge is recognized.
7. The acquisition of debt by a person related to the debtor (or about to be related) from a person not related to the debtor results in DCI.
8. For LLCs and partnerships, the determination of income is made at the entity level, but the exceptions are made at the partner or LLC member level.
9. An LLC loan is considered recourse debt to the extent it is guaranteed by some or all of the members. An LLC debt is also treated as recourse debt if a member pledges property (outside of the LLC) as security for the debt.

10. There are statutory exclusions for bankruptcy or insolvency (and some other circumstances) which has only to do with how DCI is treated in the year that the debt is discharged.

The Insolvency Exclusion (for recourse debt only)

You may exclude from your gross income debt canceled when you are insolvent, but only up to the amount that you are insolvent. HOWEVER, you must use the amount excluded to reduce your tax basis in other property or tax attributes.

You are insolvent when and to the extent that your liabilities exceed the fair value of your assets immediately before the discharge of indebtedness. You must include all assets you own in the calculation including the net liquidation value of qualified retirement accounts, life insurance cash values, annuities and the value of any businesses you own.

The information that you must have to figure your income taxes when a recourse debt is discharged includes the following:

1. Your net worth immediately before the discharge. Generally, the lower the value of your assets the lower your tax consequences. (If the discharge is delayed, careful planning may result in a reduced tax impact. Depending upon your circumstances, it may be important to obtain appraisals and inspections of all of your assets, not just the assets associated with the subject debt.)
2. The amount of debt involved and whether the lender intends to discharge the debts or if they intend to pursue collection.
3. The fair value of the property taken by the lender. This is usually the "court house" sale price but that amount may be disputed by you to your advantage or by IRS to your disadvantage.
4. You must be able to prove that you were insolvent immediately prior to the discharge. Non-recourse debt in existence at the discharge date is treated as a liability to the extent of the fair market value of the property securing the debt.

The Bankruptcy Exclusion

No amount is included in a taxpayer's gross income by reason of a discharge of indebtedness (in whole or in part) in a bankruptcy proceeding, but only if it is a Title 11 case under the jurisdiction of the court and the discharge is granted by the court.

The amount of debt discharged is used to reduce certain tax attributes of the taxpayer and then to reduce the tax basis of depreciable assets or real property held in inventory.

Tax attributes reduced include net operating losses and carryovers, capital losses and carryovers, the basis of the taxpayer's assets, both depreciable and non-depreciable, and passive activity losses.

The Exclusion for Discharge of Qualified Real Property Business Indebtedness

A taxpayer (other than C corps) may elect to exclude from gross income certain income from the discharge of qualified real property business indebtedness. The amount excluded is treated as a reduction in the tax basis of the real property, so it will increase the gain when the property is sold.

Qualified indebtedness is debt incurred to acquire, construct or substantially improve real property that is secured by the debt. Debt secured by the property for funds not used to acquire, construct or improve the property does not qualify.

The income tax rules are very complex, especially when the debtor is a partnership or LLC. Careful planning with a tax professional who is knowledgeable in this area may result in substantial savings. Building proper records to support the tax treatment chosen is essential prevent IRS penalties.

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