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Tax Issues in Foreclosure Cases

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Christopher Fasano
Staff Attorney
Mobilization for Justice, Inc.
cfasano@mfjlegal.org

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Income from Discharge of Indebtedness

Gross Income Defined

IRC § 61: "[G]ross income means all income from whatever source derived, including (but not limited to) …. *Income from discharge of indebtedness*..."

Gross income includes any "accessions to wealth, clearly realized, and over which the taxpayers have clear dominion." *C.I.R. v. Glenshaw Glass Co.*, 348 U.S. 426, 431, 75 S. Ct. 473, 477 (1955).

Common Exclusions

All income is included in a taxpayer's gross income unless it is specifically excluded. One such exclusion is certain gain from the sale of a principal residence (IRC § 121):

- Individual filers can exclude $250,000 and joint filers can exclude $500,000.
- There is a five-year look-back period to determine if the residence is the taxpayer's principal residence (i.e., the taxpayer must have owned and occupied the residence for a period aggregating two-years or more).
- This exclusion also applies to involuntary conversions (i.e., foreclosures).

Another critical exclusion is certain income from the discharge of indebtedness (otherwise referred to as cancelation of debt, or COD).

COD Defined

IRC § 108(a) Exclusion from gross income.--

(1) In general.--Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if--

- **(A)** the discharge occurs in a title 11 case,
- **(B)** the discharge occurs when the taxpayer is insolvent,
- **(C)** the indebtedness discharged is qualified farm indebtedness,
- **(D)** in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or
- **(E)** the indebtedness discharged is qualified principal residence indebtedness which is discharged--
  - **(i)** before January 1, 2017, or
  - **(ii)** subject to an arrangement that is entered into and evidenced in writing before January 1, 2017.

Hierarchy of Exclusions

The bankruptcy exclusion takes precedence over the other exclusions. The taxpayer cannot pair this exclusion with any of the other statutory exclusions (IRC § 108(a)(2)(A)).

The **qualified principal residence indebtedness** (QPRI) exclusion takes precedence the **insolvency exclusion** (IRC § 108(a)(2)(C)).

But, a taxpayer can elect to apply the insolvency exclusion instead of QPRI (IRC § 108(a)(2)(C)).

Insolvency Exclusion

The amount of the exclusion is limited by the amount that the taxpayer is insolvent (IRC § 108(a)(3)).

Insolvency is defined as the excess of liabilities over the fair market value of assets immediately before the debt discharge (IRC § 108(d)(3)).

- Liabilities includes the debt being discharged.
- Assets include everything the taxpayer owns, including assets that serve as the security for the forgiven debt and retirement plans.

IRS Publication 4681 has an insolvency worksheet you can use to determine insolvency.

Insolvency Exclusion Example

Greg owns a property worth $200,000, a car worth $10,000, household goods worth $5,000, and he has $5,000 in savings. Greg owes $210,000 on his mortgage and $40,000 on his student debt. Greg's mortgage servicer forgives $50,000 of principal.

Does Greg have any taxable income from this debt forgiveness?

Insolvency Exclusion - Answer

Yes. Greg's total liabilities are $250,000. The fair market value of Greg's assets are $220,000. Therefore, the amount of Greg's insolvency is $30,000 (his total liabilities minus the fair market value of his assets).

Greg can only exclude the amount of the insolvency from his income. Of the $50,000 forgiven, Greg can exclude $30,000. He must include $20,000 in his taxable income for that year.

Qualified Principal Residence Indebtedness: Requirements

For debt to qualify as QPRI:

- The debt must be discharged before January 1, 2017 or discharged subject to a written agreement entered into before January 1, 2017 (IRC § 108(a)(1)(E)).
- The property must qualify as a principal residence under IRC § 121 (IRC § 108(h)(5)).
- The forgiveness must be on account of a decline in the value of the residence or the financial condition of the taxpayer (IRC § 108(h)(3)).
- There is a limit of $2 million or $1 million for married filing separately (IRC § 108(h)(2)).
- The indebtedness must be “acquisition indebtedness” (IRC § 108(h)(2)).

Acquisition Indebtedness Defined

IRC 163(h)(3)(B) Acquisition indebtedness.--

(i) In general. The term "acquisition indebtedness" means any indebtedness which--

(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and

(II) is secured by such residence.

Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

A refinancing of acquisition indebtedness does not change the character of the indebtedness. But, if the taxpayer refinances for an amount greater than the acquisition indebtedness, and does not use this extra sum to construct or substantially improve a residence, then that extra sum is not acquisition indebtedness.

QPRI Example

Becky takes out a mortgage of $300,000 to purchase her home. A year later, she takes out a second mortgage of $50,000 to add a garage to her home. Five years later, she owes a combined $325,000 on both mortgages, and her property has appreciated to $430,000. She refinances for $400,000. She uses the $75,000 to pay off credit cards and to pay college tuition for her daughter.

How much QPRI does Becky have?

QPRI Example - Answer

Her QPRI is $325,000.

The $300,000 first mortgage was QPRI because she used the debt to acquire her home. The $50,000 second mortgage was QPRI because she used the debt to construct a garage. Before her refinancing, she owed $325,000, which was entirely attributable to debt that qualified as QPRI.

This $325,000 still qualifies as QPRI after the refinancing. The remaining $75,000 does not qualify as QPRI, because this sum was not used to acquire, construct or substantially improve the residence.

QPRI Ordering Rule

If the loan only consists of QPRI, then the entire amount forgiven can be excluded from income, assuming all of the other requirements for QPRI are satisfied.

But, if part of the loan does not qualify as QPRI, then only part of the amount forgiven can be excluded from income.

The taxpayer can only forgive an amount in excess of the non-QPRI (IRC § 108(h)(4)). In other words, the taxpayer's non-QPRI is forgiven first before any of the QPRI is forgiven.

QPRI Quiz: Individual Quiz
2 questions, 5 minutes

QPRI Example 4

The facts are unchanged from Quiz Question 2. Will Ken *have* to include the $115,000 of forgiven debt into his income? What else do we need to know to answer this question?

QPRI Example 4 - Answer

Ken might be able to exclude the forgiven debt from his income if he's insolvent. We would need to know the fair market value of his assets and his other liabilities.

Other Statutory Exclusions

"No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction." IRC § 108(e)(2).

- Mortgage interest is generally deductible.

In *Johnson v. Commissioner,* T.C.M. 1999-162 (1999), the borrowers owed $160,104, consisting of $129,292 of principal, $23,489 of accrued interest, $3,672 of escrow, and $3,651 of fees and expenses. The property had a fair market value of $105,000 and sold at auction for $93,251. The borrower was not insolvent at the time of the auction.

- The COD was $55,014 (the difference between the outstanding principal balance and the fair market value of the property).
- The Tax Court excluded the entire $23,489 of accrued interest from the borrower's income.
- The borrower's taxable COD was only $31,525.

Contested Liabilities

"Under the contested liability doctrine, if a taxpayer, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute would be treated as the amount of debt cognizable for tax purposes." *Zarin v. Commissioner*, 916 F.2d 110, 114 (3d Cir. 1990).

"Of course, if the debt is unenforceable as a result of an infirmity at the time of its creation (e.g., fraud or misrepresentation), tax liability may be avoided…" *Preslar v. Commissioner*, 167 F.3d 1323, 1329 (10th Cir. 1999).

Critically, the original debt must be unliquidated.

Where the dispute focuses on repayment of the loan, and not the validity of the debt, then the contested liability doctrine is unavailing.

Timing of COD

The creditor will issue a 1099-C upon the occurrence of an identifiable event.

Identifiable events include:

- A discharge of indebtedness under title 11 of the United States Code (bankruptcy);
- A cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or State court;
- A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness, or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;

Timing of COD (continued)

Identifiable events include:

- A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;
- A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- A discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration; or
- A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt.

Timing of COD (continued)

The determination is “fact specific and often turns on the subjective intent of the creditor.” *Gaffney v. Commissioner*, T.C. Summ.Op. 2010-128, 2010 WL 3397469, at *3 (Aug. 30, 2010).

The issuance of a Form 1099-C is not dispositive, nor is a bookkeeping entry by a creditor.

In *Gaffney*, the foreclosure took place in 1994. Bank of America engaged in intermittent collection activity between 1994 and 2001. It then issued the Form 1099-C in 2006. The Tax Court held that Bank of America failed to indicate an identifiable event, bank policy or state law that would justify the discharge of indebtedness taking place in 2006.

How to Claim a COD Exclusion

The creditor is required to file a 1099-C if it forgives $600 or more. The Form 1099-C lists the amount of the canceled debt, the date of the cancelation, and the reason why the cancelation is being reported in that taxable year.

The taxpayer must either include the income shown on the Form 1099-C or complete a Form 982 to exclude some or all of forgiven debt.

COD Exclusion - Reducing Tax Attributes

Taxpayers that claim COD exclusions must reduce tax attributes (IRC § 108(b)).

For bankruptcy and the insolvency exclusion, the taxpayer must reduce attributes in the following order:

- Net operating losses
- General business credits
- Minimum tax credits
- Capital loss carryovers
- Basis of the taxpayer's property

For QPRI, the taxpayer must reduce the basis of the principal residence (IRC § 108(h)(1)).

Liens and Collection Alternatives

Tax Liens in Foreclosure Cases

Tax liens can interfere with home-saving solutions.

- In some states, the liens must be removed or subordinated before the servicer will modify the mortgage.
- The lien may interfere in state or local community lending programs.

In a short sale, the borrower will have to remove or satisfy the lien.

And for borrowers who succeed in modifying their mortgage, the lien could impede their ability to refinance in the future.

Federal Tax Liens – When They Arise

A federal tax lien arises when:

- There is an assessment of federal taxes,
- The IRS issues notice and demand for payment of the assessed taxes, and
- The taxpayer fails to pay the taxes after the notice and demand.

Whenever a taxpayer's account with the IRS shows that there is a balance due, there is almost always a lien.

The scope of the lien is exceptionally broad. The tax lien attaches not just to property the taxpayer owns at the time the lien is created. It also attaches to any property the taxpayer acquires in the future.

Federal Tax Liens - Perfecting the Lien

The IRS perfects the lien by filing a Notice of Federal Tax Lien (NFTL) in an office within the state where the property subject to the lien is situated, as required under state law (IRC § 6323(f)).

The IRS can file the NFTL whenever the lien comes into existence until the expiration of the 10-year statute of limitations for collections.

If a security interest predates the filing of a NFTL, then that security interest takes priority over the NFTL (IRC § 6323(a)).

The NFTL takes priority over later-filed liens. Exceptions to this priority rule include state tax liens, special assessments and mechanics' liens (IRC § 6323(b)).

How to Address a Federal Tax Lien

1. Withdrawal
2. Release
3. Discharge
4. Subordination
5. Nonattachment

Withdrawal

There are four grounds for withdrawal, the most common of which is that withdrawing the NFTL would "facilitate the collection of tax liability." IRC § 6323(j)(1)(C).

To request lien withdrawal, the taxpayer must file a Form 12277.

Release

Within 30 days after the tax is paid or becomes legally unenforceable, the IRS must issue a certificate of release (IRC § 6325(a)).

The IRS can issue self-releasing liens, which specifically describe the circumstances when the release occurs (Treas. Reg. § 301.6325-1(a)(3)).

If the NFTL lists multiple tax periods, the IRS will not issue a certificate of release until the taxpayer satisfies the liabilities for each tax period listed in the NFTL.

Discharge

Discharge would most commonly arise in the context of a short sale.

The IRS can discharge a lien, meaning that the federal tax lien ceases to attach to one or more properties (IRC § 6325(b)).

There are four grounds for discharge, but typically, it is available to taxpayers who are divesting themselves of the property. If the taxpayer seeks to retain any interest in the property subject to the discharge request, then the IRS will deny the request.

- For example, if a taxpayer intends to sell a property for $100,000, the only mortgage has an outstanding balance of $75,000, and there is a NFTL for $60,000, the IRS can discharge the lien for $25,000 less closing costs.
- The purchaser will take title free and clear of the NFTL.
- But the taxpayer will still owe the balance of $35,000 to the IRS.

To request discharge, the taxpayer must file a Form 14135.

Subordination

The IRS can subordinate the NFTL on three grounds, including if subordination increases the amount the IRS can collect on the lien.

- "This might involve a refinance to a lower interest rate which would, if the subordination were granted, allow a larger monthly repayment rate on the tax liability." IRS Pub. 784 (Rev. 6-2010).

To request subordination, the taxpayer should file a Form 14134. The instructions are set forth in IRS Publication 784.

Nonattachment

If a NFTL is filed against the wrong taxpayer, non-attachment is the proper device to remove the lien.

The procedure applying for a Certificate of Nonattachment is set fourth in IRS Publication 1024.

Collection Alternatives

1. Offer In Comprise (OIC)

2. Currently Not Collectible (CNC)

3. Installment Agreements

Offers-in-Compromise (OIC)

In an OIC, the taxpayer offers to settle the tax deficiency for less than the amount due.

Bases for the OIC include doubt as to the liability or doubt as to the collectability.

Critically, the taxpayer must file all required returns and must provide a 20 percent deposit with the offer.

To initiate the offer, the taxpayer will complete a Form 656 and an accompanying Form 433-A.

Currently Not Collectible (CNC)

The IRS can suspend collection activity for a variety of reasons, the most common of which is economic hardship.

If the IRS places an account into CNC status, the tax deficiency is not compromised, and interest and penalties continue to accrue. If the IRS filed a NFTL, it remains in force. And the IRS will automatically offset any future refunds against the tax liability.

Installment Agreements

To qualify, all tax returns must be filed.

The current year's liability can be added to the installment agreement. Future liabilities can also be added to the installment agreement.

The taxpayer must also pay a user fee.

Although penalties and fees continue to accrue, the non-filing penalty decreases from 0.5% per month to 0.25% while the agreement is in force and the taxpayer is in good standing.

For guaranteed or streamlined installment agreements, taxpayers can file a Form 9465 or call the IRS's taxpayer help line.

Guaranteed Installment Agreements

Guaranteed Installment Agreements are available to taxpayers who (IRC § 6159(c)):

- Do not owe more than $10,000;
- Have filed all required returns for the past five years, paid all taxes due on those returns, and have not entered into an installment plan during this five-year period;
- Are unable to pay the liability in full; and
- Agree to pay the liability within three years.

Streamlined Installment Agreements

Streamlined Installment Agreements are available to taxpayers who do not meet the above requirements, but who owe less than $25,000 (I.R.M. 5.14.5.2).

- The taxpayer does not have to submit financial information along with the request.
- The maximum installment period for a streamlined installment agreement is 60 months, but the payment may not be less than $25 per month.

Installment Agreements and Lien Withdrawal

Under the IRS's Fresh Start Initiative, the IRS may withdraw the NFTL if (I.R.M. 5.12.9.3.2.1):

- The taxpayer owes $25,000 or less;
- The Direct Debit Installment Agreement provides for the payment of the amount due within 60 months or before the collection statute expires, whichever is earlier;
- The taxpayer is in full compliance with other filing and payment requirements;
- The taxpayer has made three consecutive direct debit payments; and
- The taxpayer hasn't defaulted on the current, or any previous, Direct Debit Installment Agreements.

To request lien withdrawal under this initiative, the taxpayer should file a Form 12277.

Recent Developments

Private Debt Collection

The 2015 FAST Act amended IRC § 6306 to require the IRS to enter into tax collection contracts with private debt collection agencies for ‘inactive tax receivables.’

Private collection commence after the 2017 filing season.

The IRS has awarded contracts to four agencies: Conserve (NY), Pioneer (NY), Performant (CA), and CBA Group (IA).

Private Debt Collection – Inactive Tax Receivables

An inactive tax receivable includes (IRC § 6306(c)(2)(A)):

- Tax debts that the IRS removes from its active inventory, either because it lacks resources or it cannot locate the taxpayer.
- Tax debts for which 1/3 of the relevant statute of limitations has passed and no IRS employee has be assigned to collect the debt.
- Tax debts that are in collection, but more than 365 days have passed without any interaction between the IRS and the taxpayer.

Private Debt Collection – Exceptions

IRC 6306(d) Certain tax receivables not eligible for collection under qualified tax collections contracts.--A tax receivable shall not be eligible for collection pursuant to a qualified tax collection contract if such receivable--

(1) is subject to a pending or active offer-in-compromise or installment agreement,

(2) is classified as an innocent spouse case,

(3) involves a taxpayer identified by the Secretary as being--

- **(A)** deceased,
- **(B)** under the age of 18,
- **(C)** in a designated combat zone, or
- **(D)** a victim of tax-related identity theft,

(4) is currently under examination, litigation, criminal investigation, or levy, or

(5) is currently subject to a proper exercise of a right of appeal under this title.

Questions

If you have any questions later, you can contact me at cfasano@mfjlegal.org.

Thank you, everybody.