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Short Sales and Cancellation of Debt Income

-Rani Vaishnavi Kothapalli, MST Student

Are they two different transactions or a single transaction? Let us find out with the Simonsens1.

This is a classic case which provides guidance to taxpayers and practitioners on how to calculate gain or loss on short sale of property and treatment of cancellation of indebtedness income in such instances. It provides answers to: Whether a property sold in a short sale is always going to have a cancellation of debt income, subject to tax? More specifically, in a short sale is there one or two separate transactions between the sale of the property to a third party the lender's acceptance of less than the total amount owed to them from the net proceeds of the sale? Does the fact that a mortgage on real property is a recourse or non-recourse debt?

The Simonsens were California residents who bought a townhouse in San Jose, California for $695,000 in July 2005, paying 20% down and they borrowed the rest from Wells Fargo Bank (Bank) as a nonrecourse debt (mortgage). The mortgage had an adjustable interest rate note which was secured by a deed of trust. This townhouse was their principal residence at the time of purchase. Subsequent to their purchase, they made improvements to the townhouse. In September 2010, they moved and rented out their townhouse after failing to make mortgage payments during the great recession. At that time, they converted their personal residence into a rental property. In November 2011, the Simonsens negotiated a short sale for $363,000 with the Bank and a third-party buyer. All of the sales proceeds went to the bank towards the remaining mortgage balance of $555,960 and closing costs of $26,310. In January 2012, the Bank sent the Simonsens a Form 1099-C showing that it cancelled the remaining mortgage balance of $219,270. The Simonsens also received a Form 1099-S from First America Title Company showing the sale of the house to the buyer in the amount of $363,000 with a closing date November 18, 2011.

The Simonsens prepared and properly filed their tax return for 2011 which reported a sales price of $363,000. They also reported cancellation of indebtedness (COI) income of $219,270,[2] but the they excluded the COI income, applying the Mortgage Forgiveness Debt Relief Act of 2007[3] which modified Section 108 to provide for a new COI income exclusion for discharged qualified principal residence indebtedness.[4] They took the position on the COI exclusion on the fact that the property was still eligible for the principal residence gain exclusion provisions of IRC §121 based on the amount of time the property was their principal residence prior to its sale. They reported a capital loss of $216,495 which was calculated as the difference

[1] *K.F. **Simonsen** v Commr*, 150 TC, No. 8 (2018)

[2] Cancellation of Indebtedness Income ($219,270) = Bank Loan ($555,960) + Closing Costs ($26,310) – Cash Proceeds ($363,000)

[3] Mortgage Forgiveness Debt Relief Act of 2007, (Act) Pub. L. No. 110-142, 121 Stat. 1803

[4] IRC §108(a)(1)(E)

between the adjusted basis of the townhouse of $579,495 at the time of sale and the sale proceeds from the short sale of $363,000.

In October 2014, the Commissioner sent a notice of deficiency, which included an accuracy-related penalty under Section 6662(a),[5] concluding that the short sale and the cancellation of indebtedness were both part of an integrated, single transaction. The Simonsens disagreed, claiming the sale and the COI they were separate events and properly filed a petition with the U.S. Tax Court.

Gross Income

Gross income means all income from whatever source derived, including income from discharge of indebtedness.[6] However, an exclusion from gross income includes any amount of specified, qualifying debt that is discharged if it is related to a qualified principal residence.[7] Not all mortgages on principal residences are considered qualifying indebtedness for purposes of this exclusion. Qualifying indebtedness on a principal residence generally only includes only acquisition indebtedness used to acquire, construct, or substantially improve a qualified principal residence of the taxpayer, and the debt must be secured by such residence.[8]

Recourse vs. Nonrecourse Debt

Indebtedness is classified as “nonrecourse” if the debtor is not personally liable on the debt and the creditor has rights towards only specified collateral for the debt, but not to all the debtor’s assets as a whole. Great Plains Gasification[9] case by citing Raphan case.[10] The meaning of a “qualified principal residence” is governed by IRC §121, which generally provides that gross income (up to $250,000 - $500,000 for jointly filed returns) shall not include gain from the sale of a primary residence if the taxpayer has owned and used that property as their principal residence for at least two out the five years prior to the sale. However, this provision does not answer the Commissioner’s question as to whether the townhouse was the Simonsen’s principal residence at the time of sale. However, as detailed later on, this issue ultimately was a moot point.

As mentioned previously, the Simonsens believed that there were two transactions - one causing a capital loss of $216,495 on the sale (based on the price paid by the buyer less their basis in the property at the time of the sale) of the townhouse and other resulting in COI income of $219,270, albeit exempted from taxable income under the qualified principal residence

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[5] IRC Section 6662(a) Imposition of penalty: If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.
[6] IRC §61(a)
[7] IRC §108(a)(1)(E)
[8] IRC §108(h)(2)
[9] Great Plains Gasification - Great Plains Gasification Assocs. v. Commissioner, T.C. Memo. 2006-276, 2006 WL 3804622
[10] Raphan - Raphan v. United States, 759 F.2d 879, 885 (Fed. Cir. 1985))

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indebtedness exclusion. Citing the *Briarpark*[11] case, the Tax Court determined that the sale of townhouse and cancellation of debt was one integrated transaction. In *Briarpark*, a partnership firm defaulted on their nonrecourse mortgage that was secured solely by their office building that was subject to the loan. The taxpayer found a third-party to purchase the property at a price lower than their outstanding loan amount. The bank agreed to forgive the entire remaining loan balance if the third-party purchased the property. The court held that the discharge of the loan simply represented an additional amount realized on the sale of the property, under the fundamental concepts contained in IRC §1001(b).

Computing the Gain or Loss from the Disposition of Property with Liabilities

The amount of recognized gain or loss from disposition of property is generally provided for in IRC §1001. IRC §1001(a) provides that on the sale or disposition of property the recognized gain is normally the excess of the amount realized on the sale over the asset's adjusted basis, with a recognized loss occurring if the adjusted basis exceeds the amount realized. IRC §1001(b) generally provides that the amount realized from the sale or disposition of property is the sum of any money received – including the fair market value of any non-cash property received on the sale, except for any amounts attributable to property taxes that are legally imposed on the buyer. From here it is critical to know if liabilities attached to a sold property is included in the amount realized on a sale.

In sales where seller's debt on the sold property is forgiven, the amount realized includes the amount of debt forgiven from such a sale or disposition.[12] The court referred to this concept in the holding in *Commissioner v. Tufts* [13] in which the Supreme Court held, as was noted in this case, that "when a taxpayer sells or disposes of property encumbered by a nonrecourse obligation the Commissioner properly requires him to include" in the amount realized the remaining outstanding amount of the loan at the time of sale. As such, a short sale and any cancellation of nonrecourse debt are considered part of a single transaction within a sale of property. Therefore, the Tax Court in the present case held that the debt forgiven by Wells Fargo must be added to the amount realized that is used for computing the gain or loss on the disposition of property and should not be treated as a transaction separate from the sale and reported as income from cancellation of indebtedness. Therefore, the total amount realized by the Simonsens on their short sale their townhouse was $555,960.[14]

What is the Adjusted Basis of the Property for the Simonsens?

The adjusted basis for the gain/loss computation on a sale of the type of property sold in the present case is generally defined under IRC §1011 as the original cost basis in property, adjusted upwards for any capital improvements and downwards for any applicable depreciation as provided under IRC §1016. The Simonsens purchased their townhouse for $695,000 and

[11] 2925 Briarpark, Ltd. v. Commissioner, T.C. Memo. 1997- 298
[12] Treas. Reg. § 1.1001-2
[13] *Commissioner v. Tufts*, 461 U.S. 300, 317 (1983)
[14] Amount realized ($555,960) = Cash ($363,000) + Debt Forgiven ($192,960)

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made improvements to it. They, and the Tax Court, believed that their adjusted basis in the property was (before a relatively small amount of applicable depreciation) at or above $695,000 right before it was converted to a rental property, with its fair market value being $495,000 at the time of the rental conversation in September 2010. The adjusted basis of a property converted to a rental, in the case of loss on its subsequent sale, is calculated as the lower of: (1) the fair market value of the property or (2) the adjusted basis at the time of conversion.[15] Accordingly, the adjusted basis in the property for loss computation purposes for the Simonsens was $495,000, which was the lower of its adjusted basis or fair market value before at the time of conversion. However, for *gain* recognition purposes, the lower of fair market value or adjusted basis rule does not apply, so their basis in the property in this situation was approximately $695,000.

Computation of Gain or Loss (if any) on a Sale of a Rental Conversion Property

As stated previously, the Simonsen's *gain* basis in the townhome was determined to be $695,000, but their loss basis was only $495,000. Also, as previously detailed, the amount realized on the short sale was $555,960. Since this was more than the loss basis, but less than the gain basis, no recognized gain or loss was applicable on its sale.

To understand the best way to compute gain in this case, the Court referred to how the adjusted basis is determined when a person gifts property to another. Section 1015(a) provides that the basis of the gift to the done is the generally same as that of the donors. However, if the fair market value of such gift is *lower* than the donor's basis at the time the gift is made, Treas. Reg. §1.1015(a)(1) provides that the basis to the done in case of a loss is based on the property's the fair market value. When the amount realized on the sale by the donee is higher than the loss basis, but less than the gain basis, neither gain nor loss is recognized, with the adjusted basis considered to the same amount as the amount realized. Therefore, with the same gain/loss basis rules for gifts and rental conversion properties, and with the amount realized for the Simonsens of $555,960 which was between the loss basis of $495,000 and the gain basis of $695,000, there was neither loss nor gain for them in this transaction.

The Accuracy Related Penalty

A penalty under IRC §6662(a) is issued when the taxpayer understates their tax by an amount exceeding the greater of $5,000 or 10% of the tax required to be shown on the tax return. The correct tax liability for Simonsens was $76,000 as determined by the Court and they reported only $7,000. Hence, the Simonsens were issued a 20% accuracy related penalty under IRC §6662(a). However, the burden of proof is on the Commissioner[16] who has to prove that the penalty was approved in writing by the examiner's supervisor no later than the date of notice of

[15] Treas. Reg. §1.165-9(b)(2).
[16] IRC §7491(c)

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deficiency.[17] Fortunately for the Simonsens, the Commissioner was unable to provide such evidence.

Even if the Commissioner proved that the examiner's supervisor approved the notice of deficiency on or before the date of notice of deficiency, the Simonsens could have potentially avoided the accuracy related penalty by proving that they acted with reasonable cause and in good faith in their reporting of the transaction.[18] Treas. Reg. §1.6664-4(a) lists the rules to help determine if the taxpayer acted in good faith. Such factors take into consideration the applicable facts and circumstances of the situation – including the education and experience of the taxpayer - and, with specific provisions for the reliance on an opinion or advice of a tax professional. The Simonsens could have, if needed, argued that this short sale was the first time they had to deal with such a transaction and they relied on IRS Publications 4681 and 523, as well as language included in the instructions to the Form 1099-S information return that was sent to them on the sale of the property, that could have been read to support their original tax filing position.

The *Simonsen* case is a classic case to be referred by a taxpayer when they have short sale. It helps provide solutions to complex situations such as how different types of mortgages (recourse versus nonrecourse) and a conversion of a former primary residence to a rental come into play in the gain or loss calculation – including situations where there may be a no gain or loss situation. It also gives insight on how taxpayers can avoid the accuracy-related penalty under IRC §6662(a).

[17] IRC §6751(b)(1)
[18] Treas. Reg. §1.6664-4(a)