# Income Tax Considerations Related to the Abandonment, Foreclosure, or Repossession of Collateral Property

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*Financially troubled debtors (both corporate and individual) have to face difficult decisions when they cannot honor their debt obligations. For a secured loan, the alternative may be that the debtor will either abandon the collateral property, go through a foreclosure proceeding, or have the collateral property repossessed. As if these events were not bad enough, there are often negative income tax consequences to the debtor related to these alternatives. This discussion summarizes the income tax consequences related to a collateral property abandonment, foreclosure, or repossession.*

## Introduction

In the current prolonged economic downturn, both individual debtors and business debtors may have trouble paying their mortgages, bonds, notes, and other debts. In some instances, the debtor (whether an individual or business) may have to either: (1) abandon the collateral property, (2) go through a foreclosure proceeding, or (3) have the property repossessed. Such abandonment, foreclosure, or repossession procedures may alleviate the immediate financial burden on the debtor/taxpayer. This is because, as a result of that property transfer procedure, the debtor is relieved of the debt obligation. Of course, the debtor is also "relieved" of the ownership of the collateral property.

Nonetheless, both individual and business debtors—and their professional advisers—should also consider the income tax consequences related to the abandonment, foreclosure, or repossession of the troubled debtor's property. In many instances, the debtor not only loses the collateral property. The debtor may also have to recognize taxable income related to the subject property abandonment, foreclosure, or repossession. This discussion will summarize these debtor income tax considerations.

Debtor-owned property that secures a debt may be abandoned by either a voluntary action or an involuntary action. The associated income tax consequences of the property abandonment depend, among other things, on (1) whether the debtor/taxpayer was personally liable for the debt (whether the debt was recourse or nonrecourse debt) and (2) whether or not the abandoned property was personal use property.

## Property That Is Secured by Recourse Debt

If the debtor/taxpayer is personally liable for the loan secured by the property being abandoned, then the loan is a recourse debt. In that case, until the foreclosure or repossession procedures are completed, there are no income tax consequences to the debtor/taxpayer. This statement is true whether the property is personal use property or business use property.

The collateral property foreclosure or repossession is treated as a property sale for income tax purposes. And, the debtor may realize a gain or a loss on the deemed property sale.

The amount that the debtor is considered to realize on the deemed property "sale" is the lower of (1) the property's fair market value on the date of the abandonment or (2) the outstanding debt amount immediately before the property transfer, reduced by

any amount for which the debtor/taxpayer remains personally liable after the property transfer.

For income tax purposes, the amount that is realized on the deemed property "sale" also includes any proceeds that the debtor received from the foreclosure sale. The amount realized on the property "sale" is compared with the debtor's basis in the collateral property in order to determine any taxable gain or loss on that "sale."

A gain from the foreclosure sale of abandoned collateral property is included in the debtor/taxpayer's gross income. This tax treatment applies whether or not the debtor/taxpayer used the collateral property for business purposes. However, any losses from the debtor's personal-use property are nondeductible to the debtor/taxpayer.

If the collateral property is a business-use asset, then the gain or loss on the property disposition is either (1) a capital gain or loss or (2) an ordinary gain or loss. That determination of capital status versus ordinary status will depend on the character and the nature of the particular collateral property.

Let's now consider the income tax considerations after the property foreclosure is completed. If the financial institution or creditor forgives any part of the debtor/taxpayer debt, then the forgiven debt amount is considered as cancellation of debt (COD) income. And, the COD income may be included in the debtor/taxpayer's gross income. COD income is reported separately from any gain or loss realized from the deemed sale of the collateral property.

## Property That Is Secured by Nonrecourse Debt

Now, let's assume that the debtor/taxpayer is not personally liable for the debt (e.g., it is nonrecourse debt). Let's assume that the debtor/taxpayer abandons personal-use property such as a home or an automobile. In that case, the property abandonment is treated as a sale of the property in the year of the property abandonment.

The amount realized on the sale—that is, the outstanding loan balance—is compared with the debtor/taxpayer's adjusted basis in the abandoned property in order to determine the amount of any gain or loss. Any loss is considered to be a nondeductible personal expense. If the abandoned property is a business or investment property, then the amount of gain or loss is determined in the same way. However, a loss on the deemed property sale is deductible to the debtor/taxpayer. The character of the loss depends on the character of the abandoned property.

Generally, the debtor/taxpayer will not recognize COD income from these types of abandonment transactions. This is because the debtor/taxpayer is not personally liable for the debt.

However, if the debtor/taxpayer retains the collateral property and accepts a discount from the creditor for the early payment of the debt, or if the debtor agrees to a loan modification that reduces the loan principal balance, then the amount of the discount or principal reduction is considered to be COD income to the debtor/taxpayer. This unfavorable taxation consequence occurs even if the debtor/taxpayer is not personally liable for the debt.

## COD Income Recognition

Generally, if a creditor forgives or cancels a debtor/taxpayer's recourse debt, then the amount forgiven or canceled is considered ordinary income to the debtor/taxpayer. The debtor/taxpayer may be able to exclude the canceled debt from gross income if the debt cancellation was a gift.

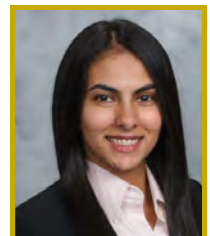
In some cases, the debtor/taxpayer can exclude the COD income from gross income if the canceled debt was a student loan, a deductible debt, or a price reduction after the original purchase of the property.

Internal Revenue Code Section 108 also allows the exclusion of COD income from gross income in the following instances: (1) if the debtor/taxpayer was in bankruptcy or insolvent immediately before the debt cancellation or (2) if the debt is (a) qualified farm indebtedness, (b) qualified real property business indebtedness, or (c) qualified principal residence indebtedness.

## Summary and Conclusion

This discussion summarized some of the unfavorable income tax consequences that are likely to arise for a debtor/taxpayer with regard to a collateral property abandonment, foreclosure, or repossession. Of course, the debtor/taxpayer's facts and circumstances may indicate a variety of options and considerations regarding these income tax consequences.

Individual and business debtors—and their financial and other professional advisers—should consider all of these undesirable income tax consequences before the debtor/taxpayer decides to relinquish property that serves as collateral on a secured loan.



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