

Income Tax Consequences to the Troubled Debtor's Property Abandonment, Foreclosure, or Repossession

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When a debtor (whether a business or an individual) cannot pay its secured obligations, the debtor has a number of options. However, all of those options generally involve the debtor losing the collateral property (through either abandonment, foreclosure, or repossession). In addition, the debtor may have to recognize taxable income related to the cancellation of the debt related to any of these options. This discussion summarizes the income tax considerations related to the secured debtor's property abandonment.

INTRODUCTION

In this current prolonged economic downturn, both individual debtors and business debtors have experienced difficulty paying their mortgages, bonds, notes, and other secured debts.

In some instances, the financially troubled debtor (whether an individual or a business) may have to either:

1. abandon the collateral property,
2. go through a foreclosure proceeding regarding the collateral property, or
3. have the collateral property repossessed.

Such a collateral property abandonment, foreclosure, or repossession procedures may alleviate the immediate financial burden on the debtor/taxpayer.

This debt relief result occurs because, due to that collateral property transfer procedure, the financially troubled debtor is relieved of the associated secured debt obligation.

Of course, that financially distressed debtor is also "relieved" of the ownership of the collateral property.

Nonetheless, both individual debtors and business debtors—and their professional advisers—should also consider the income tax consequences related to the abandonment, foreclosure, or repossession of the financially troubled debtor's collateral property.

In many instances, the debtor will not only lose the collateral property related to the secured debt default. In addition, the debtor may also have to recognize cancellation of debt (COD) taxable income related to the subject property abandonment, foreclosure, or repossession.

This discussion summarizes these debtor income tax considerations.

Debtor-owned property that secures a debt may be abandoned by either:

1. a voluntary action or
2. an involuntary action.

Among other things, the debtor's income tax consequences of the property abandonment depend on the following:

1. Whether the debtor/taxpayer was personally liable for the debt

2. Whether or not the abandoned property was considered personal use property

COLLATERAL PROPERTY THAT IS SECURED BY RECOURSE DEBT

If the debtor/taxpayer is personally liable for the loan that is secured by the abandoned property, then the secured loan is a recourse debt. In that instance, until the property foreclosure or repossession procedures are completed, there are no income tax consequences to the debtor/taxpayer.

This statement regarding no income tax consequences 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.

For income tax purposes, the amount that the debtor/taxpayer 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 property abandonment or
2. the outstanding debt amount immediately before the collateral property transfer (that debt is reduced by any amount for which the debtor/taxpayer remains personally liable after the property transfer is complete).

For income tax purposes, the amount that is realized on the deemed property “sale” also includes any amount of proceeds that the debtor/taxpayer received from the property foreclosure sale.

The amount realized on the collateral property “sale” is compared with the debtor’s tax basis in that collateral property. That comparison determines the amount of any taxable gain or loss that the debtor/taxpayer recognizes on the deemed property “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 “sale” of 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 gain status versus ordinary income status will depend on both:

1. the character of the particular collateral property and
2. the nature of the particular collateral property.

Let’s now consider the debtor/taxpayer income tax considerations after the collateral property foreclosure is completed. If the financial institution or other creditor forgives any part of the secured debt for the debtor/taxpayer, then the debt forgiveness amount is considered to be cancellation of debt (COD) income.

And, the COD income may be included in the debtor/taxpayer’s gross income. On the debtor/taxpayer’s tax return, the COD income is reported separately from any gain or loss realized from the deemed sale of the collateral property.

COLLATERAL 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, for income tax purposes, the property abandonment is treated as a sale of the collateral property in the year of the property abandonment.



“... the debtor/taxpayer can also 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 collateral property.”

The amount realized on the property “sale”—that is, the outstanding loan balance—is compared with the debtor/taxpayer’s adjusted tax basis in the abandoned property. This comparison will determine the amount of any gain or loss that the debtor/taxpayer must recognize.

Any loss on the personal use property abandonment is considered to be a nondeductible personal expense. If the abandoned property is business or investment property, then the

amount of gain or loss is determined in the same way.

However, a loss on the deemed sale of the business use property 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 cancellation of debt (COD) income from abandonment transactions related to nonrecourse debt. This tax treatment results because the debtor/taxpayer is not personally liable for the underlying nonrecourse debt.

Let’s consider the situations where:

1. the debtor/taxpayer retains the collateral property and accepts a discount from the financial institution/creditor for the early payment of the debt or
2. the debtor/taxpayer agrees to a loan modification that reduces the amount of the outstanding loan principal balance.

For income tax purposes, the amount of either the loan discount or the principal reduction is considered to be COD income to the debtor/taxpayer. This unfavorable income tax consequence occurs even if the debtor/taxpayer is not personally liable for the nonrecourse debt.

COD INCOME RECOGNITION

Generally, if a creditor forgives or cancels the debtor/taxpayer’s recourse debt, then the amount of debt forgiven or canceled is considered to be

ordinary income to the debtor/taxpayer. The debtor/taxpayer may be able to exclude the canceled debt from gross income in the event that the debt cancellation is considered to be a gift.

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

In addition, Internal Revenue Code Section 108(a) allows for the exclusion of COD income from the debtor/taxpayer’s gross income in the following instances:

1. If the debtor/taxpayer was in bankruptcy or was insolvent immediately before the debt cancellation
2. If the cancelled 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 facts and circumstances of the particular debtor/taxpayer may indicate a variety of options and considerations regarding these unfavorable income tax consequences.

Financially troubled debtors—both individual and business debtors—should consider all of these unfavorable income tax consequences before the debtor/taxpayer decides to relinquish property that serves as collateral on a secured loan. In many situations, the debtor/taxpayer will benefit from having an estimate of the fair market value of the property that secures the debt.

In addition, the debtor’s financial and other professional advisers should consider all of the potential income tax consequences when consulting with the financially troubled debtor related to the costs/benefits of a collateral property abandonment, foreclosure, or repossession.

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