

Questions**QUESTIONS****1A. JILL – SIMPLEST CASE.**

Jill owed \$2,000 on her credit card, but was having trouble making payments. She talked to the lender, and they agreed she would relinquish the card, and lender would reduce the balance to \$500.

What's her tax position?

1B. HARRY – REPOSSESSED CAR

Harry purchased a \$14,000 car for personal use. He paid \$2,000 down, and took a loan for \$12,000. A year later Harry could not keep up the payments on the car – lender repossessed. At this time, the loan had a balance of \$10,000, but the car was worth only \$8,000. Lender canceled the remaining \$2,000 of debt, even though the loan was a recourse loan. The 1099-C properly shows the \$2,000 canceled.

What's Harry's tax position?

2. LOST THE HOME

Beauregard and Florence, a married couple, are both wage earners. Their very first home in San Diego was converted to a rental 2 years ago, when they bought their second home in San Diego. Last year Bo accepted a promotion, and they moved to Ventura. They bought a third home in Ventura. The second home was on the market for several months, but property values had declined, and the bank would not accept a short sale. They could not afford to make payments on two homes, so they stopped paying on the second home in San Diego.

The bank foreclosed and sold the property for \$320,000 in a Trustee Sale. The current loan was a refinance done 1½ years ago – Bo & Flo got a better interest rate and cleared up some consumer debt – current balance is \$350,000. The bank issues Forms 1099-A and 1099-C.

How do we handle Bo & Flo's tax situation?

DEBT RELIEF BASICS

Remember Jill?

QUESTIONS

1A. JILL – SIMPLEST CASE.

Jill owed \$2,000 on her credit card, but was having trouble making payments. She talked to the lender, and they agreed she would relinquish the card, and lender would reduce the balance to \$500.

What's her tax position?

LOOKS TOO SIMPLE – BUT THIS IS THE CORE PROBLEM. Let's analyze this in little pieces:

- Jill definitely owed \$2,000 yesterday.
- Today she owes \$1,500 less.
- Jill and the lender have both agreed to this.
- Jill has \$1,500 in Cancellation Of Debt (COD) income.

Jill owed the money fair and square. The bank agreed to accept \$1,500 less. There should be no question that Jill has gained something financially. Tax law agrees with this. *Rev.Rul. 82-202 and Rev.Rul. 91-31.*

CODE SECTION 108 – POSSIBLE TAX RELIEF. There are cases in which Jill can acknowledge the income, but some or all of the \$1,500 may be, in fact, nontaxable. That's §108 of the IRC.



THE LAW SAYS IN IRC SECTION 108 - - -

A. DEBT RELIEF INCOME MAY BE EXCLUDED from income in certain cases. This is done by applying the following steps – IN EXACTLY THIS ORDER!

1. Debts cancelled in a Bankruptcy case.
2. To the extent taxpayer is insolvent immediately before cancellation.
3. For certain Farm Debt
4. For qualifying "Business Real Property Indebtedness".
5. For Qualified Principal Residence Indebtedness in 2007, 2008, and 2009. For QPRI amounts, taxpayers may elect to use this 5th provision or #2, but not both.

B. RELIEF IS NOT FREE – IN RETURN, TAXPAYER MUST relinquish certain tax attributes.

IRC Section 108

NONRECOURSE? RECOURSE₁? RECOURSE₂?

DON'T BELIEVE BOX 5!!! The type of loan determines the “sale” price, and is a MOST important question. Unfortunately, this is an area of great confusion.

SIMPLE DISTINCTION – IN THEORY. The concept sounds so simple we are tempted to make the determination ourselves:

RECOURSE loans allow lender to pursue an unpaid balance. They can turn to you, your spouse, your heirs, and more. They can look to current earnings, future earnings, your children’s earnings, and more.

NONRECOURSE loans say the lender has recourse only to recovery of the asset which secures the loan – such act is deemed to afford lender with full satisfaction of the debt.



TAX TRAP!!!

RECOURSE vs. NONRECOURSE - NOT YOUR JOB! Don't make the mistake of characterizing the loan - leave this job to others! An attorney would tell you the language of virtually EVERY loan allows for recourse – the truth depends on State laws, and the actions of lender and borrower. Every “rule of thumb” for determining recourse vs. nonrecourse has an exception! Rely on the expertise of others here. **DON'T PRACTICE LAW!**

Demand a clear statement from some source as to the character of the loan. At stake is failure to declare ordinary income from debt relief if the loan is really a recourse instrument, or reporting an incorrect sale price for the property.

IF IN DOUBT, TREAT IT AS A RECOURSE LOAN! Once you explain the implications of this to client, he'll find other documents or even pay an attorney for an opinion.

USUALLY, RECOURSE IS WORSE FOR CLIENT. Remember, if the loan is non-recourse, the sale price is “deemed” to be equal to the loan balance, and COD income is impossible. Rarely does a homeowner have any tax implications at all from the “sale”. Recourse loans, on the other hand, give rise to possible COD income – and an increase in income tax.



CALIFORNIA DIFFERENCES – PURCHASE-MONEY LOANS

Code of Civil Procedure §580(b) says a default on a loan originally taken to purchase a property with 4 or fewer residential units, one or more of which is, or will be, occupied by the borrower as principal residence cannot result in a deficiency judgment. Is it then logical to assume that a purchase money loan is always a non-recourse loan? FTB has indicated that it will treat these loans as a nonrecourse loan. However a subsequent refinance will change this.

2. INSOLVENCY EXCEPTION

INSOLVENT TAXPAYERS may exclude COD income to the extent of their insolvency. However, certain tax attributes must be adjusted, discussed later. Insolvency is measured by the extent to which FMV of liabilities exceed assets.

HOW TO CALCULATE INSOLVENCY

CALCULATE JUST BEFORE THE EVENT that gave rise to COD income. In a foreclosure, we look at the instant just BEFORE the property is lost.

ANY TAXPAYER IS INSOLVENT looking only at the property which caused a COD income. Just BEFORE the event, taxpayer is ALREADY insolvent to the extent of any shortfall on the property (\$50,000 in our discussion). Our calculation asks if the net asset value of OTHER assets will REDUCE this.

NO FORM for the calculation – use plain paper, a loan application – whatever. A possibility: Form 433-A (for individuals) or 433-B (for businesses). The IRS uses these as a financial statement. At least IRS recognizes it!

ASSETS VS. LIABILITIES. Unfortunately, you must list a value for any and all assets. This can be frightening. Prior to Year 2000 we could exclude some assets in accordance with bankruptcy exclusion rules. In Year 2000 the Tax Court decided the bankruptcy laws, as rewritten in 1980, no longer allowed this treatment. As a result - Nothing is excludable!! (*Carlson, (2000) 116 TC 87*)

PREPARE TAX RETURN

REPORT THE NET AMOUNT (IF ANY) OF THE DEBT RELIEF

Use Line 21 of Form 1040 to report the net income from debt relief, and write “SEE FORM 982 - ATTACHED”. Line 21 now shows the amount of debt relief income NOT excluded, and your statement and Form 982 can wait.

DO THE REST OF THE RETURN NORMALLY! Do not worry about tax attributes and Form 982 until the return is completed.



KEY TO UNDERSTANDING – TAX RETURN FIRST

WHAT ABOUT FORM 982? We say – LET IT WAIT!

THIS IS CRITICALLY IMPORTANT! The tax return must be completed before preparing Form 982, or you will make costly errors!

Regulations 1.108-7(b), plus examples 1 & 2 from 1.108-7(d)

BACK TO OUR EXAMPLES

1A. JILL – SIMPLEST CASE.

Jill owed \$2,000 on her credit card, but was having trouble making payments. She talked to the lender, and they agreed she would relinquish the card, and lender would reduce the balance to \$500.

What’s her tax position?

1B. HARRY – REPOSSESSED CAR

Harry owed had bought a \$14,000 car for personal use. He paid \$2,000 down, and took a loan for \$12,000. A year later Harry could not keep up the payments on the car – lender repossessed. At this time, the loan had a balance of \$10,000, but the car was worth only \$8,000. Lender cancelled the remaining \$2,000 of debt, even though the loan was a recourse loan. The 1099-C properly shows the \$2,000 canceled.

What’s Harry’s tax position?

LOTS MORE INFORMATION IS NEEDED! Harry and Jill have identical situations. We’ll look only at Harry – but, remember – Jill’s answer may or may not be similar.

A) DECLARE THE COD INCOME. Enter \$2,000 on Line 21 of Harry’s return. Next we need to ask whether anything can be forgiven. Harry did not file for bankruptcy, and this is not about a home, so - - -

B) CALCULATE INSOLVENCY

INSOLVENCY EXCLUSION might help Harry. We need to ask about all of Harry’s other assets & liabilities. Suppose we collect information about Harry’s finances *immediately prior to the repossession*:

Focus on assets vs. liabilities, PRIOR to the event causing COD.

Item	Basis	Asset Value	Liability
Item at issue: Vehicle	\$14,000	\$8,000	\$10,000
All other items			
Clothing & Personal property	\$6,000	\$3,500	\$500
Jewelry, collectibles	\$1,500	\$2,000	0
Student Loan	0	0	7,000
Cash on hand	\$500	\$500	
TOTALS	N/A	\$14,000	\$17,500
Insolvent by \$3,500			

HARRY MAY EXCLUDE THE ENTIRE \$2,000. Since Harry is insolvent by \$3,500 immediately before the cancellation, he may exclude the \$2,000. Enter negative \$2,000 on Line 21 – leaving us with a zero.

BUT - - - TAX ATTRIBUTES! Harry must now be prepared to surrender up to \$2,000 of required tax attributes.

C) COMPLETING FORM 982

WE EXCLUDED \$2,000 COD - ITS PAYBACK TIME! We said earlier we must be prepared to relinquish certain tax attributes in exchange for the COD exclusion. Harry excluded \$2,000 of COD income.

WHAT ARE TAX ATTRIBUTES? Tax attributes are the sorts of things you try to ferret out when interviewing a new client. Are there deductible carryovers – capital losses, suspended passive losses, NOL’s, contribution carryovers? Are there income carryovers – state tax refunds, installment sales? What about bases of assets, depreciation claimed in the past, pension exclusion amounts, and so on. The list is a long one.

SOME OF THESE MUST BE GIVEN UP when claiming exclusion of COD income. In this way, the exclusion is not a “gift” from Congress, but a “trade.” In exchange for current tax relief, some future benefits are relinquished. Only a few of the possible attributes are subject to loss.

DIFFERENT ATTRIBUTES FOR DIFFERENT EXCLUSIONS. There are 4 different exclusion “triggers.” They have different attributes at risk.

COMPARISON OF TAX ATTRIBUTE RULES

What kind of Tax Attributes are at risk?	
Bankruptcy or Insolvency	A special list of 7 attributes is used, and the items must be given IN ORDER. The list follows this chart
Farm Debt	Generally only “farm-type” attributes are used. Use Form 982, Line 11. See Chapter 3 of Pub 225 “Farmers Tax Guide” for a complete discussion.
Business Real Estate Debt	Only basis of business real property is used. Depreciable basis is given first. Use Form 982, Line 4. See Pub 525 “Taxable and Nontaxable Income” for complete discussion.
Residence Debt	Basis of the Residence.
How much is given up?	
Bankruptcy, Insolvency and Residence Debt	UP TO the amount of exclusion allowed. NOTE: The exclusion is allowed in full, even if taxpayer has a smaller quantity of attributes to relinquish. The balance of the exclusion is free!!
Farm Debt, or Business RE Debt	EXACTLY the amount of exclusion allowed. In fact, exclusion is limited to the available attributes. NOTE: Just the reverse of the case above! The available attributes limit the exclusion.

3. QUALIFIED PRINCIPAL RESIDENCE EXCEPTION

ELECT TO EXCLUDE COD INCOME ON UP TO \$2 MILLION QPRI. Taxpayers who experience debt relief on a loan secured by their principal residence may claim an exclusion of COD income up to \$2 Million (\$1 Million for MFS).

NOTES AND DETAILS:

QUALIFIED PRINCIPAL RESIDENCE INDEBTEDNESS (QPRI) ONLY. This new provision affects ONLY what we would call “Acquisition debt”. This is debt *incurred* to buy, build, or substantially improve a qualifying residence – this is from *IRC §163(h)(3)(B)(i)(I)*. If improvements were made without *incurring* additional debt to finance them, the improvements do not increase the qualified debt!

REFINANCING IS ALLOWED, but the QPRI may not exceed the balance of the prior loan immediately before the refinance—unless some of the proceeds of the refinance are used directly to finance a substantial improvement.

EXCESS EQUITY DEBT is not affected by this provision – we will see that it may be possible to exclude some cancellation of this debt by relying on the insolvency exception.

3-YEAR LAW ONLY. As written, the Law affects COD income experienced in 2007, 2008, and 2009.

PRINCIPAL RESIDENCE ONLY. Vacation homes, second homes and rentals are not affected. Nor is consumer debt.

EXCLUSION VS. INSOLVENCY – USE ONE, NOT BOTH. If any portion of the COD income is from forgiveness of QPRI, and could also be excluded using insolvency, taxpayer must choose the more beneficial claim. Either use insolvency, or claim the exclusion. In fact, the Code says we must *elect* to use insolvency, though IRS is silent on this – apparently, the election is signaled by the manner used in filing the return.

REDUCE BASIS BY EXCLUSION. Any exclusion claimed here reduces the basis of the property (but not below zero). If the property is disposed of (via short sale or foreclosure), Taxpayer no longer has the home *after the cancellation of the debt* – no reduction is required.

RENEGOTIATED LOANS. If the loan was reduced without a sale of the property, the exclusion can apply (but ONLY to the Acquisition Debt), but the basis must be reduced. This may lead to a future tax liability when the home is sold.

D) PASS-THROUGH ENTITIES. . If a partnership's liability is discharged, the partnership allocates the income from discharge of indebtedness to the partners as a separately stated item. The debt relief is thus reported on Form 1040 by the partners. Any available exclusions are also applied at the partner level.
(IRC §108(d)(6))

PASS-THROUGH - EXAMPLE Your client receives a K-1 showing \$20,000 on the “other income” line, and the notes to the K-1 indicate the income stems from debt cancellation. What do you do? You vaguely remember something about “Real Property Business Indebtedness” and hope to save your client by reducing basis. **WON'T WORK!!!** Your client doesn't own real estate – he owns an intangible partnership interest!! Why didn't the partnership reduce basis? It can't!

WHAT TO DO? Claim the income. There's one possible help for you. If your client is a limited partner, your claim of relief may be limited by referring to client's “outside basis”. If the partnership is terminating, client's claim of income may re-establish some amount of basis that now qualifies for deduction. Otherwise, client is stuck with the income, except for the normal provisions for exclusion of debt relief.

E) LOAN RE-NEGOTIATION - DEBT RELIEF WITHOUT FORECLOSURE is always possible. Sometimes borrower can negotiate with lender to re-write the loan balance. Lender is motivated to avoid the legal and manpower hassles of doing a foreclosure.

NONRECOURSE LOANS ESPECIALLY VULNERABLE. With nonrecourse loans lender knows he will only recover FMV in a foreclosure. In the face of declining markets many lenders agree to accept something instead of nothing!

SECOND MORTGAGE HOLDERS, TOO. Often the holder of a second mortgage cannot afford to “take over” the first mortgage if there is a foreclosure. If unable to do so, this lender will get **NOTHING AT ALL**. Aggressive borrowers can negotiate substantial reductions in this case.

ALWAYS DEBT RELIEF. This sort of transaction always produces debt relief, whether the loan is recourse or nonrecourse.

QUESTION: ZERO TAX ON CAPITAL GAIN?

YOUR CLIENT SAM calls saying he expects

- a) A Capital Gain from stocks,
- b) A Capital Gain from selling a rental,
- c) His normal Capital Gain Distribution from his mutual funds,
- d) No capital gains, but significant “qualifying dividends”, which he has heard are taxed as capital gains,

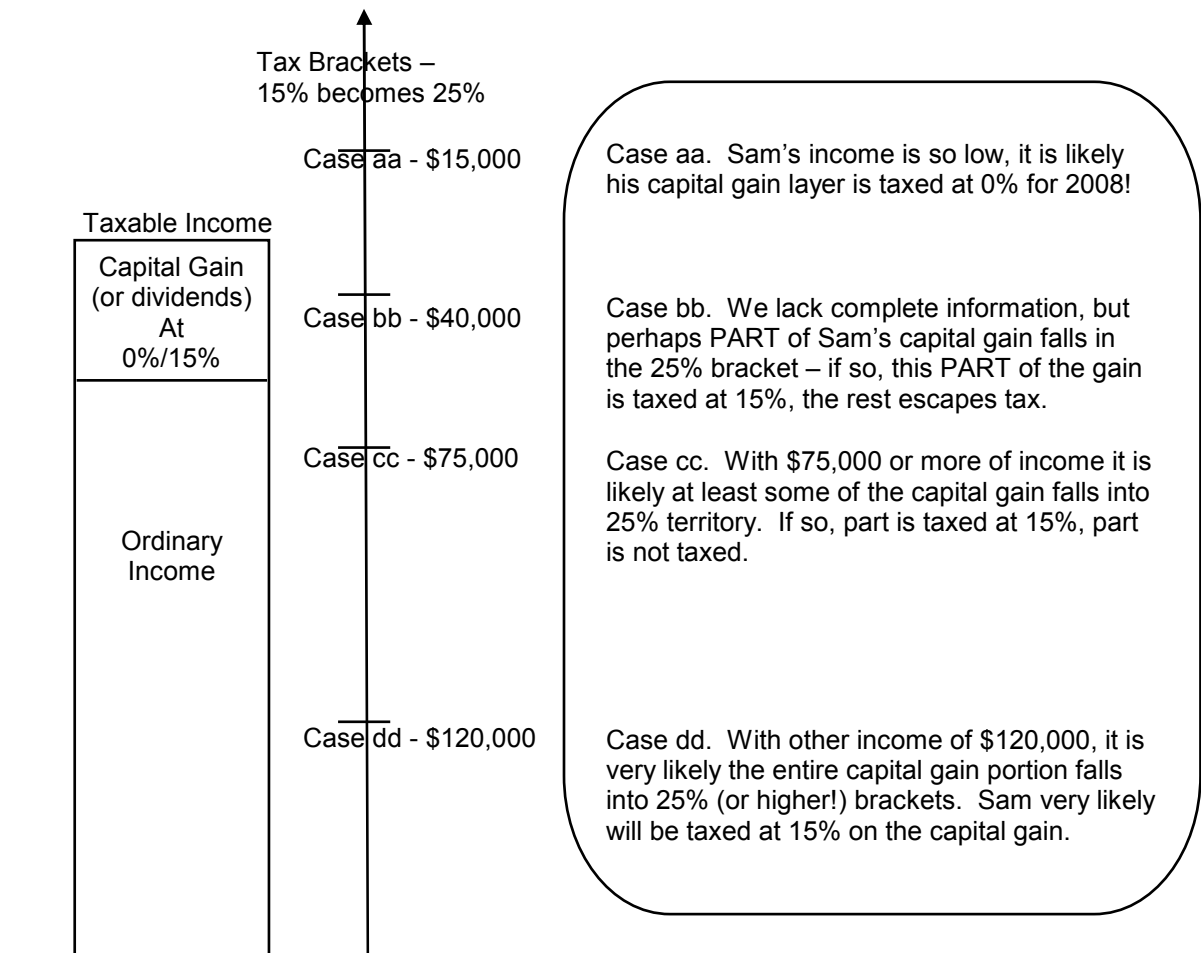
and Sam wants to know if it’s true he’ll pay no tax at all on this for 2008. Oh, yes – he wants the answer quickly!

Sam typically has other income in the general area of - - - -

- aa) \$15,000
- bb) \$40,000
- cc) \$75,000
- dd) \$120,000

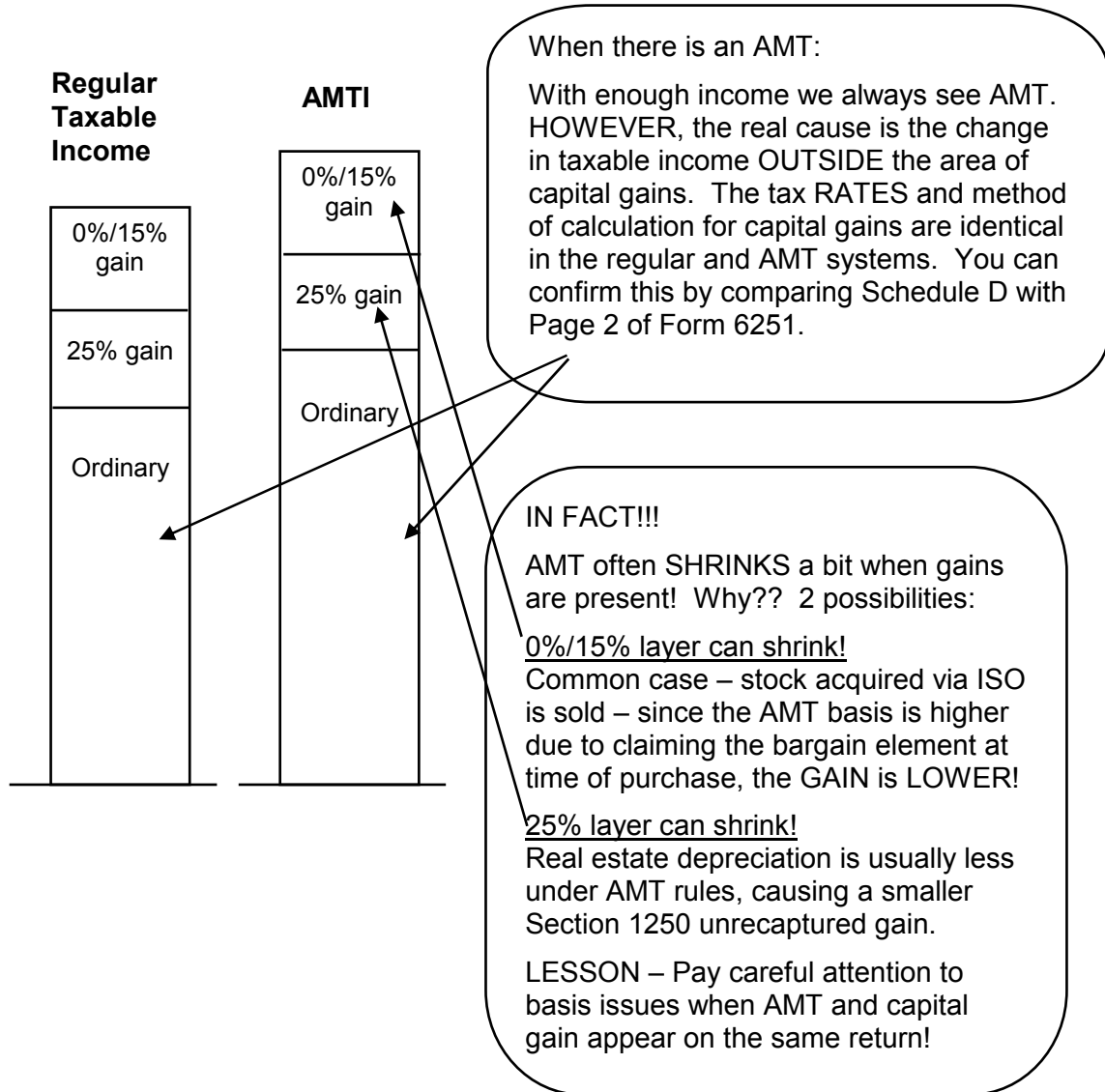
What do you tell him??

Removing the box, we can picture cases a), c), and d) in a diagram. NOTE: Sam in Case b) is tougher, and needs the longer answer on the next page.



AMT – THE GREAT MYTH

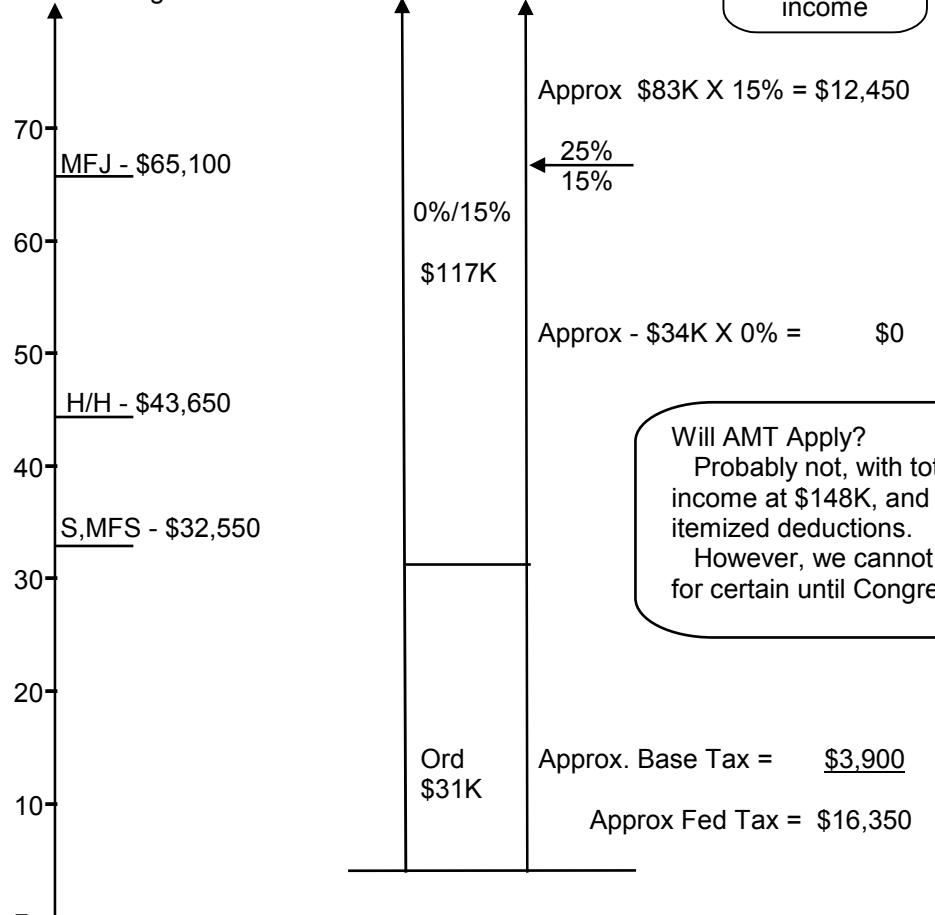
MOST PEOPLE BELIEVE CAPITAL GAIN INCREASES AMT. The truth is very different. If you're familiar with the "parallel tax return" method of dealing with AMT, the diagram below will help you understand the issue clearly.



SCHEDULE D CALCULATOR

Class	1. Reduce all sales in each class to a single entry	2. Net the L/T classes (high to low)	3. Net short or long losses (from top to bottom).	Taxable Inc
28%	(\$10K) (\$35K)	Zero	Zero	0%/15% \$115K +2K Div
25%	\$35K	Zero	Zero	28% N/A
0%/15%	\$125K	\$115K	\$115K	25% N/A
S/T	N/A	N/A	N/A	\$48K Std (\$10K) Pers (\$7K) Base Income

2008 Tax Brackets.
Where 15% becomes 25%
for different Filing Status



Qualified Dividends.
Add to the 0%/15% group
before calculating tax.

Any net S/T
gain is taxed
as ordinary
income

Will AMT Apply?
Probably not, with total taxable
income at \$148K, and no
itemized deductions.
However, we cannot answer
for certain until Congress acts.

SECTION 179

SECTION 179 allows businesses to expense (as opposed to depreciating) a limited amount of tangible personal property. This doesn't apply to rental assets. This type of depreciation must be elected—it is not automatic. When dealing with vehicles, section 179 expensing is considered to be simply part of the recovery deductions (depreciation) of the vehicle. For vehicles subject to the luxury “cap” there normally is limited benefit in claiming Section 179

Summary Chart – Section 179 Deductions					
Year	Maximum Deduction	Phase out Begins	Phase out Complete	Software	Revoke Sec 179 election on 1040X
2011 & On	\$25,000	\$200,000	\$225,000	No	No
2009 & 2010	\$128,000 indexed	\$510,000 indexed	\$638,000 indexed	Yes	Yes
2008-New	\$250,000	\$800,000	\$1,050,000	Yes	Yes
2008-Old	\$128,000	\$510,000	\$638,000	Yes	Yes
2007	\$125,000	\$500,000	\$625,000	Yes	Yes
2006	\$108,000*	\$430,000	\$538,000	Yes	Yes
2005	\$105,000*	\$425,000	\$530,000	Yes	Yes
2004	\$102,000*	\$410,000	\$512,000	Yes	Yes
2003	\$100,000*	\$400,000	\$500,000	Yes	Yes

* plus \$35,000 for NYC Liberty Zone – applies 9/11/2001 through 12/31/2006



CALIFORNIA — SECTION 179 – NON-CONFORMITY

CALIFORNIA HAS NOT CONFORMED to the 2008 Section 179 Federal increases.

CONFORMITY ENDED AT 2002. CA has NOT conformed to ANY depreciation changes since 2002.. Thus the maximum §179 deduction since 2003 is \$25,000, and phase out begins at \$200,000. In addition the election to claim or not claim §179 must be made on an original return, and may be only altered up to the extended due date of the return.

MILEAGE ALLOWANCES. IRS publishes these annually.

Year	Business miles	Deemed Deprec.	Charitable	Medical or Moving	Source
2008 thru 6/30 7/01 – 12/31	50.5¢ 58.5¢	21¢ 21¢	14¢* 14¢*	19¢ 27¢	Rev. Proc. 2007-70 & Ann 2008-63
2007	48.5¢	19¢	14¢	20¢	Rev. Proc. 2006-49
2006	44.5¢	17¢	14¢*	18¢	Rev. Proc. 2005-78
2005 thru 8/31 9/01 – 12/31	40.5¢ 48.5¢	17¢ 17¢	14¢* 14¢*	15¢ 22¢	Rev. Proc. 2004-64 & 2005-6
2004	37.5¢	16¢	14¢	14¢	Rev. Proc. 2003-76
2003	36¢	16¢	14¢	12¢	Rev. Proc. 2002-61
2002	36.5¢	15¢	14¢	13¢	Rev.Proc. 2001-54
2001	34.5¢	15¢	14¢	12¢	Rev.Proc. 2000-48
2000	32.5¢	14¢	14¢	10¢	Rev.Proc. 99-38

* Katrina contribution mileage is increased to 70% of the business rate for 2005 & 2006.



TAX TRAP!!! PENDING LEGISLATION!!

BIG TAX BREAKS FOR SUVs WOULD END. On 02-27-2008, the House passed H.R. 5351, the "Renewable Energy and Energy Conservation Tax Act of 2008." Effective for property placed in service after the enactment date, section 203 of the bill would end the current tax preference for "heavy" SUVs (over 6,000 lbs to 14,000 lbs GVW). It would subject those SUVs to the annual Code Section 280F luxury auto depreciation and Section 179 expensing limits as well as repeal the special \$25,000 Section 179 limit for "heavy" SUVs.

NOT LAW YET. Warn your clients of this legislation, but remember this provision is not a law yet!



PROPERTY TAX DEDUCTION FOR NON-ITEMIZERS

REAL PROPERTY TAX DEDUCTION is added to the components of the standard deduction for 2008. In past years, a standard deduction has been allowed for non-itemizers, with an additional amount allowed for age and blindness. In 2008 an additional amount is also allowed for real property taxes.

AMOUNT OF ADDITIONAL DEDUCTION. The amount allowed is limited to a maximum of \$1,000 for MFJ filing status and \$500 for all other filers.

EFFECTIVE DATES. For 2008 tax year only.

Housing Assistance Tax Act of 2008 (Signed 07/30/2008).



NO SECTION 121 EXCLUSION FOR NONQUALIFIED USE

NEW LAW FOR HOME SALE EXCLUSION. The code section 121 exclusion (normally up to \$250,000) will not apply to the amount of gain allocated to periods of “nonqualified use.” Note that under existing law, the code section 121 exclusion also does not apply to any gain attributable to post 05/06/1997 depreciation. This “depreciation gain” is subtracted first from the total gain to yield an “appreciation gain.” The new law applies to this “appreciation gain” only.

NONQUALIFIED USE DEFINED. “Nonqualified use” is periods of time after 12/31/2008 that a home was not used as a principal residence (e.g. was used as a second home, vacation home or rental property). A period of nonqualified use will not include any portion of the 5-year testing period (as described in Section 121) which is after the last date that the property is used as a principal residence.

ALLOCATION OF GAIN. The amount of gain allocated to periods of nonqualified use is the total “appreciation gain” multiplied by a fraction which consists of (1) the numerator which is the periods of nonqualified use during the entire ownership period of the property, and 2) the denominator which is the entire ownership period of the property.

EXCEPTIONS TO THE ALLOCATION FRACTION. The numerator will not include any nonqualified use incurred prior to 01/01/2009. However, the denominator will include all periods of ownership, even if before 01/01/2009.

EFFECTIVE DATES. For sales after 12/31/2008.

Housing Assistance Tax Act of 2008 (Signed 07/30/2008).