

Excerpts from IRS Publications 544 and 507 Regarding Form 1099-C

Foreclosures and Repossessions

If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which you may realize gain or loss. This is true even if you voluntarily return the property to the lender. You also may realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

Buyer's (borrower's) gain or loss. You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized. See *Gain or Loss From Sales and Exchanges*, earlier.



You can use Table 1-2 to figure your gain or loss from a foreclosure or repossession.

Amount realized on a nonrecourse debt. If you are not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount you realize includes the full debt canceled by the transfer. The full canceled debt is included even if the fair market value of the property is less than the canceled debt.

Example 1. Chris bought a new car for \$15,000. He paid \$2,000 down and borrowed the remaining \$13,000 from the dealer's credit company. Chris is not personally liable for the loan (nonrecourse), but pledges the new car as security. The credit company repossessed the car because he stopped making loan payments. The balance due after taking into account the payments Chris made was \$10,000. The fair market value of the car when repossessed was \$9,000. The amount Chris realized on the repossession is \$10,000. That is the debt canceled by the repossession, even though the car's fair market value is less than \$10,000. Chris figures his gain or loss on the repossession by comparing the amount realized (\$10,000) with his adjusted basis (\$15,000). He has a \$5,000 nondeductible loss.

Example 2. Abena paid \$200,000 for her home. She paid \$15,000 down and borrowed the remaining \$185,000 from a bank. Abena is not personally liable for the loan (nonrecourse debt), but pledges the house as security. The bank foreclosed on the loan because Abena stopped making payments. When the bank foreclosed on the loan, the balance due was \$180,000, the fair market value of the house was \$170,000, and Abena's adjusted basis was \$175,000 due to a casualty loss she had deducted. The amount Abena realized on the foreclosure is \$180,000, the debt canceled by the foreclosure. She figures her gain or loss by comparing the amount realized (\$180,000) with her adjusted basis (\$175,000). She has a \$5,000 realized gain.

Amount realized on a recourse debt. If you are personally liable for the debt (recourse debt), the amount realized on the foreclosure or repossession does not include the canceled

Cancellation of debt. If property that is repossessed or foreclosed on secures a debt for which you are personally liable (recourse debt), you generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession. Report the income from cancellation of a debt related to a business or rental activity as business or rental income. Report the income from cancellation of a nonbusiness debt as other income on Form 1040, line 21.

debt that is your income from cancellation of debt. However, if the fair market value of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the fair market value of the property. You are treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the fair market value. See *Cancellation of debt*, later.

Example 1. Assume the same facts as in the previous Example 1, except Chris is personally liable for the car loan (recourse debt). In this case, the amount he realizes is \$9,000. This is the canceled debt (\$10,000) up to the car's fair market value (\$9,000). Chris figures his gain or loss on the repossession by comparing the amount realized (\$9,000) with his adjusted basis (\$15,000). He has a \$6,000 nondeductible loss. He also is treated as receiving ordinary income from cancellation of debt. That income is \$1,000 (\$10,000 - \$9,000). This is the part of the canceled debt not included in the amount realized.

Example 2. Assume the same facts as in the previous Example 2, except Abena is personally liable for the loan (recourse debt). In this case, the amount she realizes is \$170,000. This is the canceled debt (\$180,000) up to the fair market value of the house (\$170,000). Abena figures her gain or loss on the foreclosure by comparing the amount realized (\$170,000) with her adjusted basis (\$175,000). She has a \$5,000 nondeductible loss. She also is treated as receiving ordinary income from cancellation of debt. That income is \$10,000 (\$180,000 - \$170,000). This is the part of the canceled debt not included in the amount realized.

Seller's (lender's) gain or loss on repossession. If you finance a buyer's purchase of property and later acquire an interest in it through foreclosure or repossession, you may have a gain or loss on the acquisition. For more information, see *Repossession* in Publication 537.



You can use Table 1-2 to figure your income from cancellation of debt.

However, income from cancellation of debt is not taxed if any of the following conditions apply.

- The cancellation is intended as a gift.
- The debt is qualified farm debt (see chapter 3 of Publication 225, *Farmer's Tax Guide*).
- The debt is qualified real property business debt (see chapter 5 of Publication 334, *Tax Guide for Small Business*).
- You are insolvent or bankrupt (see Publication 908).

Excerpt From Publication 908

Insolvency exclusion. You are insolvent when, and to the extent, your liabilities exceed the fair market value of your assets. Determine your liabilities and the fair market value of your assets immediately before the cancellation of your debt to determine whether or not you are insolvent and the amount by which you are insolvent.

Exclude from your gross income debt canceled when you are insolvent, but only up to the amount by which you are insolvent. However, you **must** use the amount excluded to reduce certain tax attributes, as explained later under *Reduction of Tax Attributes*.

The above information is not to be taken as legal or accounting advice. It is only excerpts from IRS Publications. We strongly suggest you read the entire publication and that you speak to your CPA and to your attorney to figure out whether you would be considered insolvent or bankrupt.