FORECLOSURE TAXATION

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3 Parts

1. Understand Basic Tax Consequences relating to Foreclosure

2. Taxation of SCRA Settlements

3. Q&A
TAX CONSEQUENCES IN FORECLOSURE

- Two distinct taxable Events:
  - 1. Cancellation of debt
  - 2. Gain or loss
GAIN OR LOSS ON PRINCIPAL RESIDENCE

- Gain-Exception IRC Sec. 121:
  - TP can exempt up to $250,000 in gain. ($500,000 for married filing jointly)
  - 5 year residence requirement ending on date of sale or exchange

- Loss:
  - is personal cannot offset any other income. IRC Sec. 162(c).

- See Publication 544
STATUS OF MORTGAGE

- Recourse vs Nonrecourse
  - Recourse –
    - a personal note
  - Nonrecourse - cannot hold the borrower personally liable
TAX CONSEQUENCE

- Nonrecourse debt (NRD) produces no Cancellation of debt income.
- Amount realized in foreclosure, for purpose of gain and loss on NRD, includes the full debt cancelled not just amount received in sheriff’s sale.
CANCELLATION OF DEBT

- Gross income
  - includes all income from whatever source derived IRC 26 U.S.C. Sec. 61(a).

- Gross income
  - includes COD sec. 61(a)(12)
  - The elimination of a liability makes available to the taxpayer assets previously offset to pay liabilities. United states v Kirby lumber., 52 s.Ct 4(1931)
COD

- COD can include:
  - Credit cards
  - Car Loans
  - Some Student Loans
  - Mortgages

- Any debt discharged by an applicable entity in excess of $600 when an identifiable event occurred
APPLICABLE ENTITIES REQUIRED TO ISSUE AN INFORMATIONAL RETURN

- IRC Sec. 6050P:
  - Financial Entity
  - Credit Unions
  - Governmental Units
INDENTIFIABLE EVENTS

Fed. Tax Reg. Sec. 1.6050P(b): Some events:

- Discharge in Bankruptcy
- When SOL for collection runs out
- Foreclosure
- By agreement for less than full consideration
- By defined policy of creditor
- 36 MONTH RULE
Cancellation of debt is reported to the IRS by the issuance of a 1099-C
ISSUES WITH INFORMATIONAL RETURNS

- TPs who lost home in foreclosure might not get 1099-C (last Address Rule)
- Amounts listed in Box 2 “Amount of Cancelled Debt” often inaccurate. This should be original principal less FMV of repossession if collateral
- FMV in Box 7 may be inaccurate if sale not at arms length.
DISPUTES

- TP needs to be prepared to rebut presumption that the amounts are correct.
- IRS prefers TP and Lender resolve disputes regarding information reported.
EXCLUSIONS

- IRC Sec. 108:
  - Discharge occurs in a:
  - Title 11(bankruptcy)case,
  - Discharge when the TP is insolvent.
  - Indebtedness discharged in farm indebtedness,
  - In the case of a TP other than a corporation the indebtedness discharged is qualified real property
  - Business indebtedness
  - Indebtedness discharged is principal residence indebtedness
PRINCIPAL RESIDENCE EXCLUSION

- The Mortgage Forgiveness Debt Relief Act of 2007
- IRC Sec 108(a)(1)(E):
  - Gross income does not include discharged indebtedness for a “qualified principal Residence”
  - Must be made on a timely Filed tax return.
  - Can amend within 6 months and can make election by writing “Filed Prusuant to Sec. 301.9100-2”
**PRINCIPAL RESIDENCE**

- IRC Sec. 108(h)(5) Principal Residence:
  - The home the TP ordinarily lives most of the time. IRC Sec.
- 108 (h)(5), Sec. 121.
  - Only one home.
  - No vacation homes.
QUALIFIED PRINCIPAL RESIDENCE INDEBTEDNESS

- QPRI - Acquisition indebtedness IRC Sec. 108(h)(2), Sec. 106(h)(3)(B).

- Acquisition Indebtedness
  - Acquiring
  - Constructing; or
  - Substantially improving a principal residence.

- The cancellation must be related to either:
  - A decline in value in the residence’s value, or
  - A decline in the TP’s financial situation.
REFINANCING

- QPRI also includes:
  - Debt secured by the residence for refinance provided it is to construct or improve the residence and provided it does not exceed the refinanced debt.
  - No money for credit card
  - Payoffs, vacations, new cars, student loans etc.
EXCLUSION LIMIT

- $2,000,000 Limit for QPRI. IRC Sec. 108(h)(2).
- $1,000,000 for married filing separate.
HOW TO CLAIM EXCLUSIONS

- **Form 982**
  - Complete and attach to tax return
  - Check part I depending on Exclusion.
  - Attach supporting materials: Bankruptcy Petition and discharge, or
  - Calculations of Insolvency.

__________________________
__________________________
__________________________
__________________________
**Form 982**
**Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)**

**Part I**
**General Information (see instructions)**

1. Amount excluded is due to (check applicable box(es)):
   a. Discharge of indebtedness in a title 11 case.
   b. Discharge of indebtedness to the extent insolvent (not in a title 11 case).
   c. Discharge of qualified farm indebtedness.
   d. Discharge of qualified real property business indebtedness.
   e. Discharge of qualified principal residence indebtedness.
   f. Discharge of certain indebtedness of a qualified individual because of Midwestern disaster.

2. Total amount of discharged indebtedness excluded from gross income.

3. Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? [□ Yes □ No]

**Part II**
**Reduction of Tax Attributes. You must attach a description of any transactions resulting in the reduction in basis under section 10.17. See regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part III.)**

Enter amount excluded from gross income:

4. For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property.

5. That you elected under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property.

6. Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge.

7. Applied to reduce any general business credit carryover to or from the tax year of the discharge.

8. Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge.

9. Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge.

10a. Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. DO NOT use in the case of discharge of qualified farm indebtedness.

10b. Applied to reduce the basis of your principal residence. Enter amount here ONLY if line 1e is checked.

11. For a discharge of qualified farm indebtedness, applied to reduce the basis of:
   a. Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5.
   b. Land used or held for use in a trade or business of farming
   c. Other property used or held for use in a trade or business, or for the production of income.

12. Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge.

13. Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge.

**Part III**
**Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)**

Under section 1082(a), the corporation named above has excluded $________ from its gross income for the tax year beginning ____________, and ending ____________

Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ________________ (State of Incorporation)

Note. You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.

For Paperwork Reduction Act Notice, see page 5 of this form.
WHAT IF CLIENT FORGETS?

- File appeal or correspondence letter if IRS sends CP-2000 Under-reporter notice
  - Attach information to establish position.
- Petition Tax Court.
- File audit reconsideration.
REDUCTION OF TAX ATTRIBUTES

- **Basis:** Cost IRC Sec. 1012 (a)
- **Amounts excluded under IRC Sec. 108(a):**
  - Bankruptcy and Insolvency exclusions reduce basis at the start of the next tax year:
  - Applied proportionately on all other assets owned by TP.
  - Gain recaptured on the sale of these assets attributable to the exclusion is treated as ordinary income. IRC Sec. 1017(d)
  - Report on 10(a) Form 982
**PERSONAL RESIDENCE EXCLUSION (PRE)**

- TP who excludes indebtedness under PRE are required to reduce the basis of their PR by the amount excluded.
  - Reduction is immediate. IRC Sec. 108)(h)(1).
  - Gain after foreclosure allocable to Sec. 108 exclusion for PR is subject to Sec. 121 gain exclusion $250,000.
  - Amounts in excess are subject to Capital gains rates.
  - Reported on 10(b) of Form 982
ELECTION

- If insolvency or PR exclusion apply, TP can elect depending on whichever is most beneficial.
RESOURCES

- Internal Revenue Code Title 26
- Federal Tax Regulations
- Publication 4681
- Publication 544
- www.irs.gov
Basic Tax Consequences - Recourse

- SCRA Not a Basic Foreclosure Tax Process

  - Start with Settlement

  - Break Down Settlement Payments
TAX TREATMENT OF SETTLEMENTS

Start:
- Assume Taxable under Sec 61

Is there an Exception?
- Some Non Deductable Expense reimbursement (Moving)
  - Personal or Physical Injury: Not Here
    - Compensatory – Making one whole

Return of Capital?
- Potential For Capital Gain
  - Basis in Property
  - Exceed Basis, Sec 121 Exclusion.
BAC Settlement

1. SCRA Violations – TITLE 50
   - Sec 521 (affidavits) & Sec 527 (Interest Rate > 6%)
     [URL](http://www.justice.gov/crt/about/hce/documents/scra_boa_servicing_agreement.pdf)

2. SCRA Relief
   - 597
     - Equitable relief (a)(1), monetary damages (a)(2), punitive (a)(3)
Relief Granted:

- $116,785.00 + Any lost equity in the foreclosed property + Interest accrued on lost equity.
$116,785.00

- We think this is a payment under Sec 597 (a)(2)
  - Monetary Damages

- Monetary Damages:
  - Is this payment payment compensation for personal injury?
    - No, then Taxable at Ordinary Income Rates
Lost Equity

• How is this Calculated?

• Potential For Capital Gain

• Amount Realized – Adjusted Basis = Gain.
Lost Equity:

- \([\text{Value of home at time of sale}] - [\text{previous distributions to service member or third party + any outstanding principal}]\)

- Note 3rd party above does not include junior lien holders at time of foreclosure sale.
LOST EQUITY

- Most likely either a :
  - Contemporaneous Appraisal At Time of Foreclosure
    - or
  - Retroactive Appraisal Reflecting Value at time of Foreclosure.

- Calculated as part of settlement process
  - Appraisal obtained
    - Who has it??????
Interest on Lost Equity

- Calculated from Date of Foreclosure sale until date payment issued
  - Rate set by 28 USC. Sec 1961.
HYPO 1

- John, a marine, was serving in a combat zone throughout 2008. On April 1, 2008, BAC foreclosed on John’s home. At the time, John owed $85,000 on his BAC Note and BAC purchased John’s home at auction for $85,000. John purchased his home in 2006 for $100,000. An appraisal in 2013 was obtained on John’s home to calculate lost equity. The appraisal reports that John’s house was valued at $95,000 on the date of the foreclosure sale. As part of the settlement, John received $10,000 in lost equity.
HYPO 1

- Is John’s Lost Equity Taxable?
- Basis in Home = 100,000
- Amount Realized from Sale = 95,000 (85,000 + 10,000)
- No Gain here.
HYPO 2

- Same facts as Hypo 1 except that lost equity = 20,000.

- Basis in Home = 100,000

- Amount Realized from Sale = 105,000

- Potential Gain = 105,000 – 100,000 = 5,000.

- Sec 121 Exclusion
Breakdown of Settlement

- 116,785 Monetary Damage Payment = Taxable
  - Unless can show it was reimbursement nondeductible expenses such as: living expenses incurred due to SCRA Violation.
    - Note: I could not find any mention of this in the settlement.

- Return of Equity:
  - Potential for Capital Gain.
    - AR – AB = Gain, AB > AR => no gain.

  - Primary Residence Sec 121 exclusion

- Interest on Equity
  - Taxable.
Q&A
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USDOJ Servicemembers Civil Relief Act Settlement Provisions:


In exchange for a full release of the United States\(^1\) potential civil claims\(^2\) under the Servicemembers Civil Relief Act ("SCRA"), 50 U.S.C. app. § 501, \textit{et seq.}, arising prior to the date of this agreement against Servicer\(^3\) with respect to the servicing of residential mortgages, under (a) Section 521 of the SCRA, as it pertains to mortgage foreclosure, and (b) Section 527 of the SCRA, prohibiting charging more than 6% interest on SCRA-covered mortgaged debt after a valid request by a servicemember to lower the interest rate and receipt of orders, Servicer agrees to the provisions set forth below.

I. Servicer shall comply with all the "Protections for Military Personnel" provisions in the Settlement Agreement ("Article V"). In addition, Servicer shall undertake additional remedial action and agree to the policy changes set forth below.

II. Compensation for Servicemembers and Co-Borrowers

a. Violations of Section 521 of the SCRA related to completed foreclosures on active duty servicemembers: Servicer will engage an independent consultant whose duties shall include a review of all completed foreclosures from January 1,

\(^{1}\) The following claims are specifically reserved and not released: Any action that may be taken by the appropriate Federal Banking Agency (FBA), as defined in 12 U.S.C. § 1813(q), against Servicer, any of its affiliated entities, and/or any institution-affiliated party of Servicer, as defined in 12 U.S.C. § 1813(u), pursuant to 12 U.S.C. § 1818, and any action by the FBA to enforce the Consent Order issued against Servicer by the FBA on April 13, 2011.

\(^{2}\) In \textit{United States v. BAC Home Loans Servicing, LP} (C.D. Cal.), the United States resolved its claims under Section 533 of the SCRA involving BAC Home Loans Servicing, LP, formerly known as Countrywide Home Loans Servicing, LP.

\(^{3}\) For purposes of the agreement in this exhibit, "Servicer" shall mean Bank of America N.A., Countrywide Home Loans, Inc., Countrywide Financial Corporation, Countrywide Home Loans Servicing, L.P., and BAC Home Loans Servicing, L.P., and any current affiliates and Bank of America N.A.'s successors and assignees in the event of a sale of all or substantially all of the mortgage servicing related assets of (1) Bank of America N.A., or (2) any of Bank of America N.A.'s division(s) or major business unit(s) that are engaged in servicing residential mortgages.
2006 to the present to evaluate whether the completed foreclosures were in compliance with Section 521 of the SCRA. Servicer shall propose an independent consultant and submit the independent consultant’s proposed methodology to DOJ for approval within 30 days after the entry of this agreement. The independent consultant shall begin its review within 30 days after receiving the above-referenced approvals by DOJ. The independent consultant shall submit the results of its review to DOJ within 150 days after it receives the data necessary for its analysis from the Department of Defense’s Defense Manpower Data Center (“DMDC”), providing relevant periods of military service of borrowers for completed foreclosures from January 1, 2006 to present. Based on the information gathered by the independent consultant, information submitted by Servicer, and DOJ’s independent investigation, DOJ shall make the determination reasonably based on the information it has received and its investigative conclusions whether or not a completed foreclosure was in compliance with the SCRA. In the event Servicer disagrees with the DOJ’s determination, Servicer shall be afforded 30 days to produce evidence of compliance, which DOJ shall consider in good faith. Where DOJ determines that a foreclosure was not in compliance with the SCRA, Servicer shall compensate the borrowers (i.e., any individual(s) who signed the note with respect to a foreclosed property) by providing:

1) an amount of $116,785.00 to the servicemember-borrower or an amount consistent with what was provided under the OCC Consent Order Independent
Review Process for similar violations of Section 521 of the SCRA, whichever is higher;

(2) any lost equity in the foreclosed property, as calculated by: subtracting:

(a) any outstanding principal, interest, and other amounts owing by the borrowers (excluding any fees associated with foreclosure) at the time of foreclosure, plus any junior liens and any disbursements made to the servicemember or a third party other than a junior lien holder from the proceeds of the foreclosure sale (exclusive of any fees associated with the foreclosure) from

(b) Either:

i. a contemporaneous appraisal reflecting the value of the home at the time of foreclosure;

ii. a BPO or other desktop determination of property valuation that results in property valuations reasonably consistent with those contained in contemporaneous appraisals; or

iii. a retroactive appraisal reflecting the value of the home at the time of foreclosure; and

(3) interest accrued on this lost equity, calculated from the date of the foreclosure sale until the date payment is issued, at the rate set forth in 28 U.S.C. § 1961.5

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4 Before Servicer may rely on a BPO or desktop determination for purposes of this subsection, Servicer must first obtain DOJ approval that the methodology for the BPO or desktop determination results in property valuations reasonably consistent with a contemporaneous appraisal. DOJ shall not unreasonably withhold such approval.

5 The independent consultant shall calculate the lost equity and interest described herein as part of its review.
§ 521. PROTECTION OF SERVICEMEMBERS AGAINST DEFAULT JUDGMENTS

(a) Applicability of section

This section applies to any civil action or proceeding, including any child custody proceeding, in which the defendant does not make an appearance.

(b) Affidavit requirement

(1) Plaintiff to file affidavit

In any action or proceeding covered by this section, the court, before entering judgment for the plaintiff, shall require the plaintiff to file with the court an affidavit—

(A) stating whether or not the defendant is in military service and showing necessary facts to support the affidavit; or

(B) if the plaintiff is unable to determine whether or not the defendant is in military service, stating that the plaintiff is unable to determine whether or not the defendant is in military service.

(2) Appointment of attorney to represent defendant in military service

If in an action covered by this section it appears that the defendant is in military service, the court may not enter a judgment until after the court appoints an attorney to represent the defendant. If an attorney appointed under this section to represent a servicemember cannot locate the servicemember, actions by the attorney in the case shall not waive any defense of the servicemember or otherwise bind the servicemember.

(3) Defendant's military status not ascertained by affidavit

If based upon the affidavits filed in such an action, the court is unable to determine whether the defendant is in military service, the court, before entering judgment, may require the plaintiff to file a bond in an amount approved by the court. If the defendant is later found to be in military service, the bond shall be available to indemnify the defendant against any loss or damage the defendant may suffer by reason of any judgment for the plaintiff against the defendant, should the judgment be set aside in whole or in part. The bond shall remain in effect until expiration of the time for appeal and setting aside of a judgment under applicable Federal or State law or regulation or under any applicable ordinance of a political subdivision of a State. The court may issue such orders or enter such judgments as the court determines necessary to protect the rights of the defendant under this Act [sections 501 to 515 and 516 to 597b of this Appendix].

(4) Satisfaction of requirement for affidavit

The requirement for an affidavit under paragraph (1) may be satisfied by a statement, declaration, verification, or certificate, in writing, subscribed and certified or declared to be true under penalty of perjury.

(c) Penalty for making or using false affidavit

A person who makes or uses an affidavit permitted under subsection (b) (or a
§ 527. MAXIMUM RATE OF INTEREST ON DEBTS INCURRED BEFORE MILITARY SERVICE

(a) Interest rate limitation

(1) Limitation to 6 percent
An obligation or liability bearing interest at a rate in excess of 6 percent per year that is incurred by a servicemember, or the servicemember and the servicemember's spouse jointly, before the servicemember enters military service shall not bear interest at a rate in excess of 6 percent—

(A) during the period of military service and one year thereafter, in the case of an obligation or liability consisting of a mortgage, trust deed, or other security in the nature of a mortgage; or

(B) during the period of military service, in the case of any other obligation or liability.

(2) Forgiveness of interest in excess of 6 percent
Interest at a rate in excess of 6 percent per year that would otherwise be incurred but for the prohibition in paragraph (1) is forgiven.

(3) Prevention of acceleration of principal
The amount of any periodic payment due from a servicemember under the terms of the instrument that created an obligation or liability covered by this section shall be reduced by the amount of the interest forgiven under paragraph (2) that is allocable to the period for which such payment is made.

(b) Implementation of limitation

(1) Written notice to creditor
In order for an obligation or liability of a servicemember to be subject to the interest rate limitation in subsection (a), the servicemember shall provide to the creditor written notice and a copy of the military orders calling the servicemember to military service and any orders further extending military service, not later than 180 days after the date of the servicemember's termination or release from military service.

(2) Limitation effective as of date of order to active duty
Upon receipt of written notice and a copy of orders calling a servicemember to military service, the creditor shall treat the debt in accordance with subsection (a), effective as of the date on which the servicemember is called to military service.

(c) Creditor protection
A court may grant a creditor relief from the limitations of this section if, in the opinion of the court, the ability of the servicemember to pay interest upon the obligation or liability at a rate in excess of 6 percent per year is not materially affected by reason of the servicemember's military service.

(d) Definitions
In this section:

(1) Interest
The term "interest" includes service charges, renewal charges, fees, or any other charges (except bona fide insurance) with respect to an obligation or liability.

(2) Obligation or liability
The term "obligation or liability" includes an obligation or liability consisting of a mortgage, trust deed, or other security in the nature of a mortgage.

(e) Penalty
Whoever knowingly violates subsection (a) shall be fined as provided in title 18, United States Code, imprisoned for not more than one year, or both.

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§ 597. ENFORCEMENT BY THE ATTORNEY GENERAL

(a) Civil action

The Attorney General may commence a civil action in any appropriate district court of the United States against any person who—

1. engages in a pattern or practice of violating this Act [sections 501 to 515 and 516 to 597b of this Appendix]; or

2. engages in a violation of this Act that raises an issue of significant public importance.

(b) Relief

In a civil action commenced under subsection (a), the court may—

1. grant any appropriate equitable or declaratory relief with respect to the violation of this Act [sections 501 to 515 and 516 to 597b of this Appendix];

2. award all other appropriate relief, including monetary damages, to any person aggrieved by the violation; and

3. may, to vindicate the public interest, assess a civil penalty—
   
   A. in an amount not exceeding $55,000 for a first violation; and
   
   B. in an amount not exceeding $110,000 for any subsequent violation.

(c) Intervention

Upon timely application, a person aggrieved by a violation of this Act [sections 501 to 515 and 516 to 597b of this Appendix] with respect to which the civil action is commenced may intervene in such action, and may obtain such appropriate relief as the person could obtain in a civil action under section 802 [section 597a of this Appendix] with respect to that violation, along with costs and a reasonable attorney fee.

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[SCRA NOTIFICATION LETTER FOR SECTION 521 SERVICEMEMBER]

Name of Servicemember
123 Main Street
City, State Zip code

Re: Loan Number [Insert]

Dear [Servicemember]:

We write to inform you that ______________ (the Bank), entered into a settlement on ______________, with the United States Department of Justice regarding alleged violations of the Servicemembers Civil Relief Act ("SCRA"). This settlement resolves the Department of Justice's allegations that the Bank foreclosed on servicemembers through default court proceedings without filing accurate affidavits notifying the court of the servicemembers' military statuses.

In connection with this settlement, the Department of Justice identified you as a person who may be eligible for financial compensation with respect to your loan [add loan number(s)]. Please read and carefully review the declaration attached to this letter. If it is accurate, please sign and return to us the release and declaration attached to this letter in the enclosed postage paid envelope. After we receive these documents, we will send you a check in the amount of [insert amount]. This amount includes your portion of any equity remaining in your home at the time of the foreclosure and monetary damages. In addition, the Bank will request that all major credit bureaus remove any negative entries on your credit report resulting from the foreclosure. This release and declaration must be returned by ____________.

You should be aware that the money you are eligible to receive may have consequences with respect to your federal, state, or local tax liability, as well as eligibility for any public assistance benefits you may receive. Neither the Bank nor the Department of Justice can advise you on tax liability or any effect on public assistance benefits. You may wish to consult with a qualified individual or organization about any possible tax or other consequences resulting from your receipt of this payment.

If you have any questions concerning the declaration, release or settlement or if anyone seeks to collect a debt arising from your mortgage, please contact [Insert Independent Consultant Name] at [Insert Contact Information including a phone number].