

# NEW CASE EXPLAINS TAX CONSEQUENCES UPON FORECLOSURE OF MORTGAGE

By Bob Ciancola

When real property is sold pursuant to foreclosure of a mortgage or deed of trust the federal income tax consequences can be murky. There are two aspects to consider: (1) what is the gain or loss recognized by the mortgagee on the foreclosure sale, and (2) does the mortgagee realize taxable income on the forgiveness of the underlying debt. Both these issues were addressed in the recent case of *Frazier et ux. v. Commissioner*, 111 T.C. No. 11, decided September 22, 1998.

## **Facts in the *Frazier* case.**

Taxpayers owned real property in Austin, Texas which was encumbered by a first mortgage loan in the amount of \$585,943. When the real estate market in Texas collapsed in 1989, taxpayers became insolvent and defaulted on the mortgage. The lending bank foreclosed. At the time of sale, the taxpayers had a tax basis in the property of \$495,544. According to an appraisal at the time, the property had a fair market value of only \$375,000. At the foreclosure sale, the lender was the only bidder, acquiring the property for a bid of \$571,179. Because of the state of the real estate market, the lender was not able to sell the property until 2 and a half years later for approximately \$382,000. On these facts, the IRS determined that taxpayers realized \$571,179 on the sale of their property and owed tax on a gain of \$75,635 (\$571,179 sales price less \$495,544 basis). The Tax Court disagreed, and held that the transaction must be treated as two transactions: a sale at which taxpayer recognized gain or loss and forgiveness of debt with respect to the mortgage loan.

## **Gain or loss on sale.**

Section 1001 of the Internal Revenue Code provides that upon a sale or exchange of property, the amount of gain recognized is the excess of the "amount realized" on the sale over the taxpayer's adjusted basis in the property, and the amount of loss realized is the excess of the adjusted basis over the amount realized. Where property is transferred for underlying indebtedness, the amount realized depends on whether the debt is recourse or nonrecourse to the property owner. If the debt is nonrecourse, the amount realized will include the full amount of the debt. Code section 7701(g) provides that the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject. Where the debt is recourse to the property owner, Treas. Regulation § 1.1001-2 provides that the amount realized is the fair market value of the property. When property is sold at a foreclosure sale, it is normally auctioned to the highest bidder. When that bidder turns out to be the debt holder, any amount bid at or below the outstanding loan amount will not require an exchange of cash. Therefore, to determine the amount realized, the usual practice is to look at the amount bid. The Court found, however, that in the facts of this case, that amount was not indicative of the value of the property.

The Court noted that the debt holder was the only bidder at the foreclosure sale and that it was not an arms-length transaction. It noted that the lender might have reasons for submitting a bid in excess of the property's value, including not wanting to recognize a loss on its books. Here, the appraisal submitted by the taxpayer was not rebutted by the

government and the Court therefore held that the appraised value of \$375,000 was the fair market value and therefore the amount realized.

**Forgiveness of debt.**

Where a taxpayer is forgiven a debt, there is generally a recognition of income. Section 108(a) of the Code provides that an exception to the recognition of forgiveness of debt income occurs to the extent a taxpayer is insolvent at the time the debt is forgiven. In situations such as the *Frazier* case, both gain or loss and forgiveness of debt may come into play. The taxpayers cited the IRS's own ruling 90-16 for the proposition that the transaction must be bifurcated into these two pieces. In an interesting twist, the IRS argued against its own ruling and told the Court it did not have to follow IRS rulings. The Court, however, found the ruling to be an accurate statement of the law. Having determined that the amount realized on the sale was \$375,000, the Court found the taxpayers received forgiveness of debt income in the amount of the difference between that amount and the amount of the debt. Due to their insolvency, however, the taxpayers in *Frazier* were able to invoke the exception in section 108(a) and did not have to take the forgiveness of debt into taxable income. The final result, therefore, was that the taxpayers recognized a loss on the foreclosure of \$120,544 (\$495,544 basis less \$375,000 amount realized) and did not have to recognize forgiveness of debt income of \$210,943 (\$585,943 debt less \$375,000 amount realized on sale).

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