



# Real Estate Report

Second Quarter 2010 Volume 5, Number 2



## Cancellation of Debt Income - Part 2

by: Tom Cox, Tax Supervisor

*This is the second in a series of articles discussing the tax consequences of Cancellation of Debt (COD). In his first article, Tom discussed what constitutes COD income. In this article, Tom discusses ways to either defer or eliminate tax on COD Income (CODI).*

### **Exclusion of CODI from Gross Income**

The tax code provides for exclusion of CODI from gross income under specific circumstances:

1. A discharge of debt via the bankruptcy court
2. The discharge occurs while the taxpayer is insolvent
3. The debt is qualified farm indebtedness (QFI)
4. The taxpayer, other than a C corporation, the debt discharged is qualified real property business indebtedness (QRPBI)
5. Qualified principal residence indebtedness (QPRI) discharged before 2010

If CODI is excluded, the taxpayer must reduce the following tax attributes in order:

1. Net operating losses
2. General business credits
3. Minimum tax credits
4. Capital loss carryovers
5. Basis of depreciable property is reduced
6. Passive activity losses and credit carryovers
7. Foreign tax credit carryovers

The reductions are made on a dollar for dollar basis except for credits. Credits are reduced by 33 1/3 cents per dollar. The taxpayer may make an election to reduce the basis of depreciable property instead of reducing the other tax attributes. This election is made in the year of discharge on a timely filed return.

The remainder of this article will focus on exclusion number 4, QRPBI.

### **Qualified Real Property Business Indebtedness**

Section 108 of the Internal Revenue Code provides taxpayers with a way to exclude CODI from gross income. In order to qualify for this exclusion, the debt must have been incurred before January 1, 1993 in connection to real property used in a trade or business. If the debt was incurred or assumed after this date, the debt must be qualified acquisition indebtedness (QAI). QAI is defined as debt incurred to acquire, construct, or substantially improve the property. Refinanced debt may qualify as QAI up to a certain extent. The refinanced debt cannot exceed the principal balance of the paid off loan. Any proceeds received above the amount of the balance of the old loan will not be considered QAI. If the proceeds of the refinance are used to substantially improve the property, the portion used for such purposes will be considered QAI.

The QRPBI is an election made by the taxpayer on Form 982. The form is filed with the return and is considered effective with a timely filed return, including extensions.

The election is made in the year the CODI is incurred. It is important to note that California conforms to the federal law on this matter.

Here is a small example of the workings of the QRPBI exclusion:

In July of 2004, the taxpayer purchased a rental property for \$450,000. The down payment is \$90,000 and the remainder is financed with an interest only loan with full recourse. In January of 2009, the borrower defaults. The fair market value (FMV) of the property is \$250,000; the loan balance is still \$360,000. The lender forecloses and discharges the loan. The basis of the property is \$450,000 less the depreciation of approximately \$45,000, or \$405,000.

The CODI resulting from the foreclosure is \$110,000 or \$360,000 loan value less the \$250,000 fair market value. The taxpayer files the Form 982 and excludes the \$110,000 from gross income. The basis of the property is reduced to \$295,000 (\$405,000 less \$110,000 exclusion). There would be a loss on the "sale" of \$45,000 (\$250,000 fair market value less the \$295,000 adjusted basis).

If in the above example, the fair market value exceeded the qualified acquisition indebtedness, the QRPBI exclusion could not be used. For example, let's assume the value of the rental property went to a million dollars at some point. The owner refinances the loan for \$900,000 and does not use the proceeds to improve the property. Again, in January of 2009, the borrower defaults.

## 2010 A Good Time to Transfer Wealth to the Next Generation

By: Rick Evans, Director of Valuation Services

There has never been a better time to shift or transfer wealth from one family member to another. Here are four good reasons to transfer now rather than later:

1. Due to the current recession real estate, marketable securities and closely held business values are depressed. The economy will eventually turn around and the future asset appreciation will accrue to the younger generation. It makes sense to transfer within the family during depressed economic times when values are low and sell to unrelated third parties in good economic times when values are high.
2. Applicable federal interest rates (AFR) are currently very low. Therefore, low interest intra-family loans can be a cheap way to sell assets to the younger generation.
3. The real estate market and securities markets are highly volatile which should result in large valuation discounts when these assets are transferred by way of family limited partnerships or family limited liability companies.
4. There is a possibility that House of Representatives bill HR 436 named the Certain Estate Tax Relief Act of 2009 will pass. The passage of this bill would, amongst other things, eliminate the valuation discounts associated with the transfer of most family limited partnerships and family limited liability companies. Also, The Treasury Department's "Green Book", released on May 11, 2009 proposes to modify the application of IRC S 2704(b) which would result in measure restrictions on liquidation of an interest that are measured against standards prescribed by the Treasury Regulations rather than the default state law. This would result in reduced valuation discounts.

It is likely that at some point the government will be successful in its attempt to reduce or eliminate valuation discounts. Therefore, it is important to complete gifts of entity interests now (such as family limited partnership interests and family limited liability company interests), where the entity owns nonbusiness or passive investments.

### *Cancellation of Debt Income continued from page 1*

This time, there is a FMV of \$650,000. The loan balance is \$800,000. The CODI in this scenario is \$150,000 (\$800,000 less \$650,000). Only \$450,000 of the loan is QAI, since the proceeds of the refinance were not used to improve the property. There is no QRPBI exclusion since the qualified debt does not exceed the FMV of the property. There is a gain on the sale of \$245,000 (\$650,000 - \$405,000 of adjusted basis).

### **Deferral Election**

If a taxpayer is unable to qualify for any of the above exclusions, the new tax laws allow for the deferral of CODI on a reacquisition of debt. Reacquisition occurs, as discussed above, when a portion of the debt is forgiven or there is a significant modification of the original agreement. The deferral election is made by the taxpayer in the year the CODI is incurred. The CODI is deferred to 2014

and included on a pro rata basis in the years 2014 through 2018. If the election to defer is made in the 2010 tax year, the same rules apply, thereby reducing the deferral period to four years from five.

### **Summary**

There are many instances where the CODI trap could be sprung upon an unknowing taxpayer. It is critical to involve your tax advisor before the property is foreclosed, sold short or you enter into negotiations with the lender on restructuring the debt. Your tax advisor will be able to project the implications of a certain course of action in light of your entire tax situation. There are also timing issues to be considered in enacting a course of action.

If you missed our last Newsletter issue and want to read Cancellation of Debt Income - Part I, contact Pamela Raumer at 925-274-5740 or praumer@rina.com.



## Ask the CPA

By: Larry Mar, Principal

**Q:** Will the transfer of my LLC interest cause a reassessment of the real property my brother and I purchased and contributed to the LLC? Will the LLC retain the current assessed value for future transfers of ownership?

**A:** Changes in ownership of an entity may trigger reassessment of the underlying real property. Since you and your brother purchased the property originally, you are considered "original co-owners." The LLC will retain the current assessed value (with the statutory annual increase of 2%) so long as you retain a 50% combined ownership. Rather than transferring an interest outright, you should consider having the LLC distribute the property to you and your brother, pro-rata, as tenants-in-common (TIC) first. Subsequent transfers of TIC interests, if properly executed, should avoid reassessment, as long as that transfer is less than 50% of your original TIC interest. The TIC interests could then be transferred to a new LLC.



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