Financial Distress
Chapter 1
2020 National Income Tax Workbook™
Financial Distress

- Issue 1: Foreclosures and Repossessions
- Issue 2: Cancellation-of-Debt Income
- Issue 3: Abandonments
- Issue 4: Debt-Related Information Returns
- Issue 5: Bad-Debt Deduction
- Issue 6: 2020 Relief Loans and Grants
Polling Question – CH 1 – Financial Distress

1. Which type of financial distress is the most prevalent with your clients?

A. Foreclosures
B. Repossessions
C. Cancellation-of-Debt Income
D. Abandonments
E. Bad-Debt Deduction
Foreclosures

- Treated as a sale
- Borrower has gain or loss
- Difference between amount realized and adjusted basis
Recourse loan (personally liable)

- Amount realized is smaller of:
  
  1. Outstanding debt immediately before the transfer reduced by any amount taxpayer is personally liable for immediately after the transfer

    OR

  2. FMV of the transferred property

- Amount realized also includes any proceeds received from sale
Example 1.1

- Lorna buys land ($100,000) to build primary residence
- $20,000 down and financed $80,000
- Personally liable and land secured loan
- 2020 loan balance = $65,000 & FMV of land = $110,000
- Bank foreclosed, sells land for $110,000, applies proceeds to loan balance and excess paid to Lorna.
- Lorna recognizes $10,000 gain ($110,000 amount realized - $100,000 adjusted basis).
Example 1.2

- Same Facts as Example 1.1
- Except FMV of Lorna’s land declined to $60,000
- Bank forecloses, sells land for $60,000 & forgave the $ 5,000
  - Lorna has $5,000 cancellation-of-debt income
  - Lorna has $40,000 loss
    ($60,000 amount realized on the sale – $100,000 basis)

  PERSONAL USE ASSET - NO DEDUCTION
Table 1-1. **Worksheet for Foreclosures and Repossessions**

Keep for Your Records

<table>
<thead>
<tr>
<th>Part 1. Complete Part 1 only if you were personally liable for the debt (even if none of the debt was canceled). Otherwise, go to Part 2.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property</td>
</tr>
<tr>
<td>2. Enter the fair market value of the transferred property</td>
</tr>
<tr>
<td>3. <strong>Ordinary income from the cancellation of debt upon foreclosure or repossession.</strong> Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Part 2. Gain or loss from foreclosure or repossession.</th>
</tr>
</thead>
<tbody>
<tr>
<td>4. Enter the <strong>smaller</strong> of line 1 or line 2. If you didn't complete Part 1 (because you weren't personally liable for the debt), enter the amount of outstanding debt immediately before the transfer of property</td>
</tr>
<tr>
<td>5. Enter any proceeds you received from the foreclosure sale</td>
</tr>
<tr>
<td>6. Add line 4 and line 5</td>
</tr>
<tr>
<td>7. Enter the adjusted basis of the transferred property</td>
</tr>
<tr>
<td>8. <strong>Gain or loss from foreclosure or repossession.</strong> Subtract line 7 from line 6</td>
</tr>
</tbody>
</table>

* The income may not be taxable. See chapter 1 for more details.
Nonbusiness foreclosures

- Nonrecourse loan (not personally liable), Amount realized = amount of debt
- Repossession satisfies debt – no COD income

**Example 1.3** – nonrecourse loan:
- Amount realized is $65,000 loan balance
- $35,000 nondeductible loss
Business property

- Foreclosure/Repossession on business property:
  - Capital gain or loss
    - OR
  - Ordinary income or loss
- Gain included in income
- Loss may be deductible
Forgiven loan included in income (unless exception/exclusion)

COD income = difference between amount of debt & amount accepted (including FMV of property) in satisfaction of the debt
Example 1.4

- Don borrowed $20K to buy $23K truck (personal use)
- Bank repossessed truck ($12K FMV & $15K loan balance)
- Bank sells truck for $12,000 and discharged $3,000
- Effect on Donald:
  - $11,000 nondeductible loss ($12,000 FMV - $23,000 basis)
  - $3,000 COD income ($15,000 loan balance - $12,000 FMV)
COD income – exceptions

- Gift
- Deductible debt [I.R.C. § 108(e)(2)]
  - Example 1.5 Lost Deduction – mortgage interest
- Purchase price reduction
  - Example 1.6 Price Reduction – seller reduced b/c home inspection issues
COD Exclusions – Bankruptcy

- Debtor under court jurisdiction (Title 11, Chapters 7, 11, & 13)
- Cancellation by the court or court ordered plan
- Applies at Individual level
COD Exclusions – Insolvency

- Liabilities exceed assets immediately before discharge
- Exclusion limited to amount of insolvency
- Use Pub. 4681 Insolvency Worksheet (Fig. 1.2) to calculate
Example 1.7

- Gary released from obligation to pay $5,000 personal credit card debt

<table>
<thead>
<tr>
<th></th>
<th>COD Income</th>
<th>$5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>FMV of Assets</td>
<td></td>
<td>$7,000</td>
</tr>
<tr>
<td>Insolvency Amount (excluded COD)</td>
<td></td>
<td>$3,000</td>
</tr>
<tr>
<td>Recognized COD</td>
<td></td>
<td>$2,000</td>
</tr>
</tbody>
</table>
COD Exclusions – Qualified Farm Debt

- Owed to a qualified person – actively and regularly lends money

- Incurred directly in the taxpayer’s trade or business of farming - at least 50% of aggregate gross receipts for 3 prior years attributable to farming

- Farm COD income is subject to SE tax
Excluded cancelled farm debt NOT > sum of:

1. Taxpayer’s adjusted tax attributes

AND

2. Total adjusted basis of qualified property the taxpayer held at the beginning of the tax year following the year of the discharge
COD Exclusions – Qualified Real Prop. Bus. Debt

- Qualified Real Property Business Indebtedness (QRPBI) is:
  - Incurred to acquire, construct, reconstruct, or substantially improve real property used in trade or business (and refinancing)
  - Must be secured by real property

- Depreciable Rental Property may qualify for RE developers

- Exclusion Limit cannot exceed excess of:
  - Outstanding principle amount of indebtedness, over
  - FMV of real property reduced by the outstanding principle amount of any other QRPBI secured by such property
COD Exclusions – Qualified Principal Residence Debt

- Qualified Principle Residence Indebtedness (QPRI) is:
  - Mortgage to buy, build, substantially improve main home (and refinancing of that mortgage)
  - Secured by the main home

- Check State Law – exclusions MAY be different

- Exclusion Limit:
  - Limited to $2M ($1M MFS)
  - Extended through 2020
Ordering rules for COD exclusions

1. Bankruptcy
2. Qualified principal residence debt
3. Insolvency
4. Qualified farm debt
5. Qualified real property business debt

* Taxpayer can elect #3 instead of #2
Reduction in Tax Attributes

- COD exclusion only defers tax
- Generally, tax attributes reduced by excluded amount
- File Form 982

FIGURE 1.3 (p. 10) Tax Attribute Reduction Rules
Polling Question – CH 1 – Financial Distress

2. A cancellation of debt allows a taxpayer to avoid income tax?

A. True
B. False
Example 1.8

Ex. 1.8 Facts

- In 2015 - Sloan purchased principal residence for $600,000
- In 2020 - Bank modified the loan & discharged $50,000
- Effect on Sloan:
  - Excludes $50,000 QPRI
  - $50,000 basis adjustment for QPRI
  - 2021 Sells home for $700,000
  - Gain = $150,000 ($700,000 – $550,000) - §121 exclusion?
Exclusions for bankruptcy/insolvency reduce 7 tax attributes:

- NOL,
- General business credit,
- Minimum tax credit,
- Capital loss carryovers,
- Basis,
- PAL carryovers and credit carryovers,
- Foreign tax credit carryovers
Electing basis reduction

- Taxpayer can elect to first reduce basis of depreciable assets before reducing other attributes.
  - Election made on Form 982, Line 5.
  - Real property held as inventory or primarily for sale can be treated as depreciable property.
## FIGURE 1.4 Doug Henderson's Tax Attributes

<table>
<thead>
<tr>
<th>Tax Attribute</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior-year NOL carryover to 2020</td>
<td>$400,000</td>
</tr>
<tr>
<td>Basis in office building</td>
<td>60,000</td>
</tr>
<tr>
<td>Basis in land under office building</td>
<td>90,000</td>
</tr>
<tr>
<td>Basis in equipment</td>
<td>50,000</td>
</tr>
<tr>
<td>Basis in real estate held for sale</td>
<td>5,000,000</td>
</tr>
<tr>
<td><strong>Total tax attributes</strong></td>
<td><strong>$5,600,000</strong></td>
</tr>
</tbody>
</table>
## FIGURE 1.6 Doug Henderson’s Form 982 Attachment—No Section 108(b)(5) Election

Statement for 2020 Form 982, line 10a Doug Henderson

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis before Reduction</th>
<th>Allocation of Basis Reduction</th>
<th>Basis Reduction</th>
<th>Basis after Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office building</td>
<td>$ 60,000</td>
<td>Entire</td>
<td>$ 60,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>Land under office building</td>
<td>90,000</td>
<td>Entire</td>
<td>90,000</td>
<td>0</td>
</tr>
<tr>
<td>Equipment</td>
<td>50,000</td>
<td>Entire</td>
<td>50,000</td>
<td>0</td>
</tr>
<tr>
<td>Real estate held for sale</td>
<td>5,000,000</td>
<td>$80,000 to each parcel</td>
<td>400,000</td>
<td>4,600,000</td>
</tr>
<tr>
<td>Total</td>
<td>$5,200,000</td>
<td></td>
<td>$600,000</td>
<td>$4,600,000</td>
</tr>
</tbody>
</table>
Example 1.10

Same Facts as Example 1.9

- Doug wants to save his NOL
- Elects to reduce basis in depreciable property first
- Elects to treat property held for sale as depreciable property
**FIGURE 1.8 Doug Henderson’s Form 982 Attachment—With Section 108(b)(5) Election**

Statement for 2020 Form 982, line 10a Doug Henderson

<table>
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<th>Asset</th>
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<tr>
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<td>$ 60,000</td>
<td>Entire</td>
<td>$ 60,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>Equipment</td>
<td>50,000</td>
<td>Entire</td>
<td>50,000</td>
<td>0</td>
</tr>
<tr>
<td>Real estate held for sale</td>
<td>5,000,000</td>
<td>$178,000 to each parcel</td>
<td>890,000</td>
<td>4,110,000</td>
</tr>
<tr>
<td>Total</td>
<td>$5,110,000</td>
<td></td>
<td>$1,000,000</td>
<td>$4,110,000</td>
</tr>
</tbody>
</table>
Limits on personal use property is smallest of:

- Basis of personal use property held at beginning of year after year of discharge
- Amount of cancelled nonbusiness debt excluded from income
- Excess of total basis of property & money held over total liabilities immediately after cancellation
### Example 1.11

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>FMV</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Car</td>
<td></td>
<td>$7,000</td>
<td>$8,500</td>
</tr>
<tr>
<td>Furniture</td>
<td>$5,000</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Jewelry</td>
<td>$500</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>Savings Account</td>
<td>$600</td>
<td>$600</td>
<td></td>
</tr>
<tr>
<td>Student Loan</td>
<td></td>
<td></td>
<td>$6,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td>$11,600</td>
<td>$14,500</td>
</tr>
</tbody>
</table>
Example 1.11 cont’d

Basis reduction limit is the smallest of:

- **$5,500** basis of personal use property held at the beg. of 2021 ($5K furniture + $500 jewelry)
- **$1,500** nonbusiness debt she is excluding from income
- **$100** excess of total basis of property & money held immediately after the cancellation over her total liabilities ($5,500 personal use property + $600 savings account – $6,000 student loan balance)

So Elaine must reduce her basis by the $100 as follows:

- The furniture’s basis is 91% of her total adjusted basis ($5,000 ÷ $5,500), so she reduces it by $91 ($100 × 91%).
- The jewelry’s basis is 9% of her total adjusted basis ($500 ÷ $5,500), so she reduces it by $9 ($100 × 9%).
Qualified Farm Indebtedness

- Tax attributes reduced same as in bankruptcy / insolvency,

- EXCEPT - Only basis of qualified property is reduced
  1. Depreciable qualified property
  2. Land held or used in farming
  3. Other qualified property
Qualified real property business debt exclusion, reduce only basis of depreciable real property

Reduction occurs at earlier of:

- Beginning of tax year following discharge
- Immediately before disposition
Repayment of Cancelled Debts

- TP included COD income in income
- Later repaid the debt
- May be able to file claim for refund for year debt was included as income
- Not a deduction in year repaid
Gain from transfer of Assets & COD Income

- Property transferred and debt cancelled – may have gain and COD income

- 2 Exceptions:
  - Recourse debt
  - Purchase-money debt
Example 1.12

- Dmitri had a $500,000 recourse business loan secured by office building with $350K basis and $400K FMV.
- Transferred deed in lieu of foreclosure and bank cancelled the loan.
- $50,000 (FMV – basis) gain and $100,000 (discharged debt – FMV) COD income.
- If nonrecourse $150,000 gain and $0 COD income.
Abandonments

- Voluntarily & permanently gives up possession and use

- Tax consequences depend on TP being personally liable for debt or not (recourse or non-recourse)

- Property securing recourse debt – no gain or loss until foreclosure complete
Example 1.13

- Juanita had a 200K recourse loan to purchase a house
- In 2020 loan balance was $185,000 and FMV $150,000
- Juanita moves out and mails the keys to the lender
- No foreclosure in 2020 – no gain or loss
Nonrecourse debt – abandonment treated as sale or exchange, amount realized = nonrecourse debt

Example 1.14

Juanita’s debt was nonrecourse. When she abandoned the home, she had a $15,000 loss ($185,000 amount realized - $200,000 basis)

NONDEDUCTIBLE personal loss
Debt related information returns

- 1099-A abandonments/acquisitions
- 1099-C cancellation of debt
- If debt is cancelled and property is abandoned/acquired in the same year – only issue Form 1099-C
Canceled debt - Identifiable events

- Identifiable events are:
  - Discharge of indebtedness under Bankruptcy Code
  - Debt becomes unenforceable in a receivership, foreclosure, or similar proceeding in a federal or state court
  - Expiration of statute of limitations for collections
  - Election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor’s right to pursue collections
  - Probate or similar proceeding that render a debt unenforceable
  - Lender and debtor agree to discharge
  - Lender’s decision or policy to not collect
3. If a TP abandons their residence and the bank cancels the debt in the same year, what information return(s) needs to be filed by the bank?

A. 1099-A
B. 1099-C
C. Both 1099-A & 1099-C
D. None
Example 1.16

- Don owns a snowboard shop
- $100,000 recourse loan secured by shop
- 2020 foreclosure
- FMV = $75,000
- Loan balance = $80,000
- Bank sale = $75,000 discharged = $5,000
- Bank issues 1099-C
Cozzi v. Commissioner, debt canceled/discharged based on facts & circumstances

Owens v. Commissioner, issuance of Form 1099-C is not dispositive of an intent to cancel debt

Parker v. Commissioner, IRS has no duty to investigate third party payment report that is not disputed

Portillo v. Commissioner, if taxpayer reports different amount than reported on 1099-C, IRS must show information report is correct

1099-C income may not have to be included if taxpayer paid the debt later

Taxpayer may have COD income and receive no 1099-C
Bad debt deduction

- Partially or totally worthless debt
- **Business** – may claim deduction
- **Nonbusiness** – may claim short-term capital loss
- Business bad debts defined as:
  - Debts created or acquired in taxpayer’s trade or business, OR
  - Debts related to taxpayer’s trade or business when they become worthless
Business bad debt examples

Ex. 1.17 - Created in business: Allen extends credit to Brian then Allen sells the business and retains the claim against Brian

Ex. 1.18 - Related to business: Allen did not retain the claim against Brian and the new owner has a business bad debt

Ex. 1.19 - Unrelated to business: Allen instead sells the debt to Denise. Denise does not have a business bad debt

Ex. 1.20 - Debt acquire from decedent: Allen died and left the business to his son. His son has a business bad debt
Bona Fide Debt defined:

- Debtor-creditor relationship
- Enforceable obligation to pay

Accrual method taxpayer - Included in receivables, deemed to be enforceable

Cash method taxpayers - unpaid salaries/wages, rent, fees, interest or dividends NOT BAD DEBT
Types of business bad debts:

- Loans
- Credit sales
- Business loan guarantees
Business loans

Loan or capital contribution – *Dixie Dairies* 13 factors:

1. Names parties involved
2. Fixed Maturity Date
3. Source of Payments
4. Right to enforce payments
5. Participates in Mgmt,
6. Preferential treatment
7. Intent of parties
8. Interest between creditor & S/H
9. Stability of capital structure
10. Ability to obtain outside credit
11. Use of funds
12. Failure to repay
13. Risk involved
Credit Sales

- Sell good on credit
- Perform services for promise of future payment
- Ex. 1.22 Cash method taxpayer Priya performs services but never gets paid. No bad-debt deduction
- Ex. 1.23 Accrual method taxpayer Priya includes the service income when the services are performed. Bad-debt deduction when debt becomes worthless
Business Loan Guarantees

- Taxpayer makes the guarantee in course of trade or business
- Taxpayer has a legal duty to pay the debt
- Guarantee made before the debt became worthless
- Reasonable consideration for making the guarantee
Example 1.24:

- Loretta sells her clothing line at a dress shop.
- Loretta Guarantees loan to shop so it can stay in business.
- Shop defaults & Loretta’s company paid outstanding loan.
- Loretta can claim a business bad-debt deduction.
Totally Worthless Debt

- No chance it will be paid
  - Reasonable steps to collect
  - Judgment from a court would be uncollectible

- Two Methods to Claim:
  1. Specific charge-off method
  2. Nonaccrual experience method
Nonbusiness Bad Debts

- Debts other than business debts

- Examples:
  - Ex. 1.25 - Gift to child with no obligation to repay is not a nonbusiness debt
  - Ex. 1.26 - Loan to son with note and obligation to pay is a nonbusiness debt
  - Ex. 1.27 - Deposit for kitchen cabinets is a nonbusiness debt
Reporting the Loss:

- Short-Term capital loss on F. 8949
- Attach Statement includes: description (date due & amount); debtor and relationship to TP; efforts made to collect; and why debt is worthless.
2020 Relief Loans and Grants

- Economic Injury Disaster Loan (EIDL)
  - Must be repaid – not included in taxable income

- EIDL Advance
  - Does not have to be repaid – likely included in taxable income (impacts forgiveness of Paycheck Protection Program).

- Paycheck Protection Program (PPP)
  - Forgiven loans not included in gross income,
  - Cannot deduct payment of expenses that result in loan forgiveness
  - EIDL advance is deducted from amount eligible for forgiveness
4. How many of your clients received a Paycheck Protection Program loan?

A. 10 or more
B. 7 to 9
C. 4 to 6
D. 1 to 3
E. None
THANK YOU!