

Taxman collects, even when you abandon your assets

BY DENNIS DOMRZALSKI | SPECIAL TO NMBW

Sometimes it seems as if insult really is added to injury.

Some Albuquerque developers and businesspeople are discovering that walking away from a property and letting the bank have it back has put them in a situation where they face federal income taxes on the portions of their loans that were forgiven or written off.



Kim-Miller

It's called cancellation of indebtedness income (COD) by the IRS, and it's hitting more people as the economic downturn continues to take its toll, said Matt Kim-Miller, an attorney with the Brownstein Hyatt Farber Schreck law firm's Albuquerque office.

"It's a real shock, and it comes out of the blue," said Kim-Miller, while adding that those who are negotiating loan workouts with banks need to understand the potential tax obligations upfront.

"Now, not only is someone propertyless, but the IRS also says, 'You owe us, and you are being taxed.'"

Loans not considered income

Under normal circumstances, a loan is not considered income by the IRS because the borrower has an obligation to repay it, Kim-Miller said. But if any part of a loan is forgiven, the IRS considers the forgiven portion income and levies taxes on it.

For instance, if someone owes \$10,000 on a credit card and the card company settles for \$5,000, the card holder is on the hook for federal taxes on the \$5,000 that was forgiven, because the IRS considers it cancellation of indebtedness income, Kim-Miller added.

"The hit is whenever you are relieved of the obligation to pay back the indebtedness," Kim-Miller added. "This comes up with givebacks of property. You are on the hook for taxes on the amount that the debt exceeds the sale price at the time."

It works like this:

"Say you took out a \$1 million loan on a property that was worth \$1.2 million, and now the value has declined and is now worth \$500,000," Kim-Miller explained. "You give back the property to the bank, and you are deemed by the IRS to have \$500,000 worth of income, and that comes as a shock. Or, you have \$1 million of debt on a property and you sell the property for \$800,000 and the bank approves. If the bank relieves you of the \$200,000 difference, then you will owe federal tax on that \$200,000."

Being taxed that way isn't easily avoided, because banks are obligated to report any cancellation of indebtedness.

There are exceptions. One is going through bankruptcy.

"In bankruptcy, the cancellation of indebtedness can be canceled," Kim-Miller said. "People need to contemplate bankruptcy before giving back property."

Another exception is insolvency.

"If your entity owes more than the value of its assets, then, to the extent of that insolvency, you can avoid cancellation of indebtedness. If you owe \$1 million and your assets are \$500,000, and you have COD of \$700,000, you can reduce it by \$500,000."

IRS publication 4681 explains it

The Internal Revenue Service's publication 4681 explains how canceled debts apply to income tax reports and gives examples of exceptions and exclusions, such as bankruptcy or insolvency.

Loans for residences are mostly exempt from COD, if the (debt) was used to acquire the property or to improve it and live in it, Kim-Miller said.

However, second mortgages on residential property that were used to buy cars or take vacations are not exempt.

There are also exceptions for businesses. Properties that are used to house the business, say a warehouse for products, can avoid some COD, Kim-Miller added.

"The thing that tugs at the heartstrings is that these effects come only at the time you have reached irresolvable financial difficulties, because if you could pay, you would," Kim-Miller said. "Whenever someone is saying, 'You owe me, but you don't have to pay it,' then you are going to have this issue."

"Often, it is like being between a rock and a hard place, and you have to take the rock."