



Asset Exchange Company

1031



Understanding the Taxation of Short Sales And 1031 Exchange Updates

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Member of the Federation of Exchange Accommodators



Bank with Union Bank of California



Errors and Omissions Insurance and Fidelity Bond through Lockton Insurance Brokers

Department of Consumer Affairs
California Board of Accountancy

Member of the CA Board of Accountancy



Member of the State Bar of California

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Galaxy Office Park, Concord CA

- \$42,000,000 Sale Price
- 3 LLC owners, with multiple LLC members
- \$11MM in unsecured debt
- Buyers and sellers decided to prorate the sales price in different manners between 3 parcels



Sandy Springs Apartments, Atlanta GA

- \$26,000,000 Sale Price
- 27 individual TIC owners
- Each individual owner conducting separate exchange



Brittan Ave Condo, San Carlos CA

- \$617,000 Sale Price
- 2 owners
- One owner conducting an exchange

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1031 Exchange Updates



1031 Exchange Basics

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Basic Requirements

1. Property Qualifications

- Investment or Business

2. Tax Deferral Requirements

- Reinvest all cash.
- Purchase price equal to or greater than replacement property sale value.

3. 180 Day Time Line

4. Day 45 ID

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Recent Trends in 1031 Exchange

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1031 Exchange Trends

- Quick Flips
- Seller Financing
- Reverse Exchanges
 - Buy First, then sell
- No Appreciation Exchanges

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No Appreciation Exchanges

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Example

Facts:

\$1,000,000 purchase price
\$1,000,000 sales price

Problem:

\$200,000 depreciation
- Depreciation lowers basis

Tax Liability:

25% Depreciation Recapture Tax
\$50,000 tax bill

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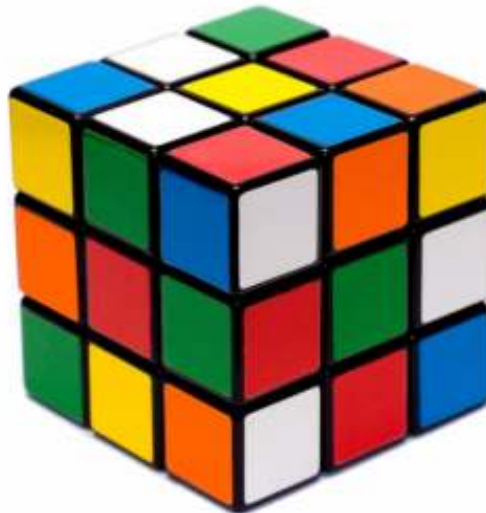
Increased Taxes

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- **In 2009, the California state capital gain tax increased from 9.3% to 9.55%**
- **In 2010, the top tax rate on capital gains and qualified stock dividends will be 15 percent.**
- **In 2011, married couples with taxable income over \$231,000 and single people with more than \$190,000 would pay 20 percent on dividends and capital gains.**

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Understanding the Taxation of Short Sales



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Short Sale Taxation

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Debt Relief/Cancelled Debt

According to the IRS, "if you owe a debt to someone else and they cancel or forgive that debt, the canceled amount may be taxable."

Examples of Debt Relief

- Short Sale
- Loan Modification
- Principal Reduction

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Original Purchase Example:

Down Payment:	\$200,000
Purchase Money, 1st Loan:	\$700,000
Purchase Money, 2nd Loan:	<u>\$100,000</u>
Original Purchase Price:	\$1,000,000

Short Sale Example:

Short Sale, Sales Price:	\$600,000
Lender Owed:	<u>\$800,000</u>
Debt Relief:	\$200,000

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Short Sale Taxation

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Debt Relief Taxation:

Bank Issues 1099C for \$200,000 for Cancellation of Debt Income
Debt Relief is taxed as **ordinary income**

<u>Tax</u>	<u>Debt Relief Income</u>	<u>Amount Owed</u>
35% Federal	\$200,000	\$70,000
9.55% State	\$200,000	<u>\$19,100</u>
Total		\$89,100

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When is Debt Relief NOT Taxed:

- **Bankruptcy**
- **Insolvency**
- **Certain farm debts**
- **Foreclosure on a Non-recourse loan:** Forgiveness of a non-recourse loan resulting from a foreclosure does not result in cancellation of debt income. However, it may result in other tax consequences.

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When is Debt Relief NOT Taxed:

If you qualify for:

- The Mortgage Forgiveness Debt Relief Act of 2007 (federal)
- The Conformity Act of 2010 (state)

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The Mortgage Forgiveness Debt Relief Act of 2007:

- The debt must be secured by the home.
- Both mortgage restructuring and foreclosures qualify.
- Available for the years 2007 through 2012.
- The Act applies only to forgiven or canceled debt used to buy, build or substantially improve your principal residence, or to refinance debt incurred for those purposes.
- Exclude up to \$2 million (\$1MM if married filing separately) of debt forgiven or canceled by a mortgage lender on a primary residence.

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The Conformity Act of 2010 (State):

- The debt must be secured by the home.
- Both mortgage restructuring and foreclosures qualify.
- Available for the years 2007 through 2012.
- The Act applies only to forgiven or canceled debt used to buy, build or substantially improve your principal residence, or to refinance debt incurred for those purposes.
- Limits debt relief to **\$500,000** for taxpayers who file as married/RDP filing jointly, single, head of household, or widow/widower, and to **\$250,000** for taxpayers who file as married/RDP filing separately.

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Original Purchase Example:

Down Payment:	\$200,000
Purchase Money, 1st Loan:	\$700,000
Purchase Money, 2nd Loan:	<u>\$100,000</u>
Original Purchase Price:	\$1,000,000

Short Sale Example:

Short Sale, Sales Price:	\$600,000
Lender Owed:	<u>\$800,000</u>
Debt Relief:	\$200,000

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Debt Relief Taxation:

Bank Issues 1099C for \$200,000 for Cancellation of Debt Income

**Client qualifies for “The Mortgage Forgiveness Debt Relief Act of 2007”

** Client qualifies for the “Conformity Act of 2010”

<u>Tax</u>	<u>Debt Relief Income</u>	<u>Amount Owed</u>
35% Federal	\$0	\$0
9.55% State	\$0	\$0
Total		\$0

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Qualifying for Debt Relief:

Federal

- File form 982

State

- Qualifying taxpayers who have already filed their 2009 tax returns should file [Form 540X, Amended Individual Income Tax Return](#), to subtract the amount of debt relief from income.
- To expedite processing, write “**Mortgage Debt Relief**” in red across the top of the amended tax return.
- Taxpayers must attach a copy of their federal return, including [Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness \(and Section 1082 Basis Adjustment\)](#), with their state tax return.

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Refinance Example:

Original Purchase Price: \$1,000,000

Down Payment: \$200,000

Purchase Money, 1st Loan: \$800,000

HELOC \$100,000 →



Short Sale Example:

Short Sale, Sales Price: \$600,000

Lender Owed: \$900,000

Debt Relief: **\$300,000** (\$200K original + \$100K HELOC)

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Debt Relief Taxation:

Bank Issues 1099C for \$300,000 for Cancellation of Debt Income

**Client qualifies for “The Mortgage Forgiveness Debt Relief Act of 2007” and “Conformity Act of 2010” – however HELOC funds do NOT qualify.

<u>Tax</u>	<u>Debt Relief Income</u>	<u>Amount Owed</u>
35% Federal	\$100,000	\$35,000
9.55% State	\$100,000	<u>\$9,550</u>
Total		\$44,550

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Short Sale Taxation Summary:

- Most clients will not pay taxes on any cancelled debt in a short sale:
 - Unless >\$500K of debt is forgiven
 - Unless the debt was used to buy, boats toys, etc.
- Clients with LOTS of HELOC debt that is forgiven may be in BIG trouble.

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Foreclosure vs. Short Sale

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Short Sale mostly preferred when:

- You qualify for the state and federal debt forgiveness laws
 - Credit score not damaged as severely
 - You control the sales price.

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Foreclosure vs. Short Sale

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Foreclosure could be preferred when:

- Debt relief greater than \$500K
- All the debt is non recourse

Why

- Foreclosure treated as a sale
- All non recourse debt is not taxed in a foreclosure.

Problems

- Credit score will be more severely impacted
- Lender controls sale price

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Foreclosure vs. Short Sale

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Issues with Short Sales & Foreclosures

- Recourse debt forgiveness is most likely taxable in a short sale or a foreclosure
- No debt relief for second homes or investment properties
- Losses from the sale or foreclosure of personal property are not deductible.
- Capital gains tax liabilities may still be owed!

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Second Homes & Investment Property :

1. The amount of cancelled of debt (COD) income is treated as a reduction in the basis of the taxpayer's depreciable real property.
2. COD can result in larger capital gains tax treatment
3. Short sale most likely preferred with second homes and foreclosures so owner can control sales prices

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Investment Property Example:

Original Purchase Price:	\$100,000 (all cash)
HELOC	\$500,000

Short Sale Example:

Short Sale, Sales Price:	\$300,000
Lender Owed:	<u>\$500,000</u>
Debt Relief:	<u>\$200,000</u>

Basis/Gain Calculation:

Original Basis:	\$100,000
Debt Relief:	<u>\$200,000</u>
New Basis:	\$0.00

Excess Debt Relief:	\$100,0000
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Capital Gains Tax:

Sales Price	:	\$300,000
Less Basis		<u>\$0.00</u>
Gain:		\$300,000

Tax (15% Fed 9.55% State):		<u>25%</u>
Capital Gains Tax Bill:		\$75,000

Ordinary Income Tax:

Excess Debt Relief:		\$100,000
Ordinary Income Taxes (State & Fed)		<u>45%</u>
Ordinary Income Tax:		\$45,000

Total Tax Bill:		\$120,000
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Insolvency:

If you are insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable to you. You are insolvent when your total debts are more than the fair market value of your total assets. Insolvency can be fairly complex to determine and the assistance of a tax professional is recommended if you believe you qualify for this exception.

Form 982 – used to report the information and items needed to prove insolvency.

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Additional Resources:

IRS Publication 4681, - Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals) is new and addresses in a single document the tax consequences of cancellation of debt issues.

<http://www.irs.gov/pub/irs-pdf/p4681.pdf>

<http://www.irs.gov/individuals/article/0,,id=179414,00.html>

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